

The Financial Impact of Direct and Indirect Taxes on a Company in Business Rescue

by

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2/29/2016



Declaration

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Abstract

Companies form the backbone of the South African economy and contribute significantly to the tax revenue of the country through both direct and indirect taxes. As a result of the 2007/2008 financial crisis businesses, especially private companies, have been under increasing financial pressure with many companies finally being liquidated as a result of these financial pressures.

In 2011, as a means to aid financially distressed companies, the government introduced the concept of Business Rescue ("BR") into law through Chapter 6 of the Companies Act, No 71. of 2008 ("Companies Act"). Despite this attempt by government to provide companies with a means of financial relief BR has been relatively unsuccessful in SA with very few companies managing to be rescued.

Companies due to their very nature are subject to many laws and regulations. It is for this reason that, when trying to consider the effectiveness of a particular law or regulation, one must look not only at the primary law but also consider the impact of any auxiliary laws and regulations that work in conjunction with the primary law. This dissertation therefore seeks to understand the financial impact of direct and indirect taxes ("Tax Laws") on a company in BR in order to determine whether these laws support or hinder BR.

In this dissertation an overall understanding of BR is obtained by considering the development of BR in SA, the BR process as detailed in the Companies Act and the application of BR in SA including various statistics relating to BR. Thereafter we obtain an overall understanding of the Tax Laws that have been introduced in to SA law since the introduction of BR in SA law as well as some existing provisions of the Tax Laws that are applicable to companies in BR. From the understanding of these two laws we develop a financial evaluation criterion that is used to assess the financial impact of various tax strategies on a company in BR.

For the final assessment of the financial impact of the Tax Laws an assessment is performed on the deductibility of BR expenditure in terms of S11(a) and 23(g) of the Income Tax Act, No. 58 of 1962 ("ITA").

Ultimately a conclusion is reached on the financial impact that the Tax Laws have on a company in BR and, at a high level, additional considerations that may improve the success rate of rehabilitating companies in BR.

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Abbreviations

Abbreviation	Definition
ADR	Alternative Dispute Resolution
Amendment Bill	Taxation Laws Amendment Bill
BR	Business Rescue
BRP	Business Rescue Practitioner
CAPEX	Capital expenditure
CAPM	Capital asset pricing model
CC	Close Corporation
CIPC	Companies and Intellectual Property Commission
CIT	Corporate Income Tax
Companies Act	The Companies Act, No. 71 of 2008
DCF	Discounted Cash Flow
Debt Relief	Debt reductions for less than full consideration
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortisation
EV	Equity Value
Explanatory Memorandum	Explanatory Memorandum Taxation Laws Amendment Bills
FCF	Free Cash Flow
Gearing	Level of debt relative to the level of equity in a company
IMF	International Monetary Fund
Insolvency Act	Insolvency Act No. 24 of 1936
ITA	Income Tax Act, No. 58 of 1962
Old Companies Act	Companies Act No. 61 of 1973
PAYE	Pay-as-you-earn
Restore	To reinstate the good condition, operation, or capacity of a company as well as ensure that the company is able to regain its former rank, privileges and rights
S	Section
SA	South Africa
SARS	South African Revenue Services
Tax	Taxation
Tax Laws	Direct and Indirect Tax Legislation
TRP	Takeover Regulations Panel
VAT	Value-Added Taxation
VAT Act	Value-Added Tax Act, Act No. 89 of 1991
WACC	Weighted average cost of capital

1. Chapter 1: Overview

1.1. Background

It is widely acknowledged that business, particularly companies, form the backbone of the economy. Companies contribute directly to the economy in terms of employment, innovation, product/service demand and supply as well as being significant tax contributors. As of 31 July 2013 there were 696 089 (CIPC, 2013) registered active private and public companies in South Africa ("SA") which contribute ZAR 179.5 billion (SARS, 2014) to the fiscus through Corporate Income Tax ("CIT") and ZAR 237.7 billion through Value Added Tax ("VAT") during the 2013/2014 financial tax year; companies thus contribute in excess of 46% of the taxes collected by government. SA has identified business, particularly small business, as a key player to reducing unemployment and poverty.

In 2007/2008 (IMF, 27 April 2009) the world economy was severely impacted by the financial crisis, never before had the global economy been affected to this scale before. SA did not experience the full impact of the global recession at this time due to the large amounts of government and private spending taking place for the 2010 soccer World Cup as well as other government initiatives and reform. This is not to say that SA managed to escape the financial crisis or its negative impact, but rather that this impact was delayed and somewhat minimised in SA.

Despite this from 2008 to 2011 the number of new companies and close corporations ("CC's") registered per year decreased from 294 132 to 167 805 (a 43% decrease); 11 843 companies and CC's were liquidated (both voluntary and forced); and 3 777 514 companies and CC's were deregistered (CIPC, 2013). From this data it was thus evident that both forms of businesses were in a dire situation.

Liquidation is a very final and permanent situation for a company; it is in essence the 'death' of a company. During liquidation the company is forced to sell all of its assets in an attempt to settle its outstanding liabilities and in most situations creditors are forced to accept a partial receipt of cash as full and final settlement of their debt, with some creditors not receiving any settlement at all. At the end of the liquidation process the company officially ceases to trade and is deregistered. Liquidation is therefore a less than ideal situation for all stakeholders; employees lose their jobs, suppliers lose money, owners lose their livelihood and the *fiscus* loses part of its tax base (this is not even taking into account the indirect impact to the economy as a whole that is caused by this).

Government sought to remedy this situation and provide companies with a 'life line'. On 1 May 2011 the Companies Act, No 71. of 2008 ("Companies Act") was introduced and which replaced the previous Companies Act. With the introduction of the Companies Act came the introduction of Business Rescue ("BR") (CIPC, 2013). BR is detailed in Chapter 6

of the Companies Act (S128 to S154), and is a process designed to assist companies that are in or see themselves heading into financial distress in the short-term. The BR process is meant to assist a company in returning to a financially stable and sustainable position.

BR is not a unique idea and even before being implemented in SA it has been used by many other countries, such as the United States, Canada, the United Kingdom, Australia and New Zealand.

Since its introduction into SA law in 2011, BR has so far been largely unsuccessful. The official stats show that less than 15% (Mazars, 2013) of companies that enter into BR are able to successfully return to a stable and sustainable financial position. While the international success rate of BR is low at approximately 30% (Mazars, 2013), this is still more than double the success rate of SA.

Companies, by their very nature, are complex organisations that are subject to many laws and regulations. It is for this reason that, when trying to consider the effectiveness of a particular law or regulation that impacts on a company, one cannot look at any single law or regulation in isolation. One must look not only at the primary law but also consider the impact of any auxiliary laws and regulations. This scope of this dissertation is therefore focused on assessing the impact that direct and indirect tax laws (“Tax Laws”) have on a company in BR.

1.2. Research objective

The main aim of this dissertation is to consider the financial impact that the application of direct and indirect taxes has on a company in BR and whether they have any impact on the success of BR.

BR is a relatively new concept to SA law and, as with most new laws and regulations, there exists several ambiguities within the legislation. These ambiguities therefore add to the complexity in interpreting and applying the legislation. Further to this there have been very few successful BR proceedings and legal cases pertaining to BR that can be used to assist in clarifying such ambiguities for BR practitioners and The South African Revenue Services (“SARS”).

Throughout this process in order to make the research more targeted, meaningful, and useful, focus has been placed on analysing and assessing the financial impact that the application of Tax Laws has on a company in BR. Consideration has also been given to identifying where the application of Tax Laws have not been addressed or otherwise considered by those involved in the BR industry. Financial impact in the context of this dissertation is taken to have a wide meaning and includes both actual financial loss as well as potential and theoretical financial loss.

While this dissertation will most likely not provide answers to all of the issues raised during this process it will also aim to:

- Provide insight into some of the current difficulties experienced with the application of Tax Laws to companies in BR;
- To better equip those in the BR industry with information and knowledge that they can use when applying the Tax Laws to companies in BR; and
- Provide a platform for others to work from and elaborate on for further research.

1.3. Research method

This dissertation will be exploratory in nature and various measurement criteria will be considered in order to evaluate the financial impact of particular Laws on a company. After selecting the most appropriate measurement ‘tool’ this will be used to assess the extent of the financial impact on a company by using example situations of companies in BR. Information will be sourced from the following:

- The Companies Act;
- The Companies Act No. 61 of 1973 (“Old Companies Act”);
- Income Tax Act, No. 58 of 1962 (“ITA”);
- Value-Added Tax Act, Act No. 89 of 1991 (“Vat Act”);
- BR cases that have taken place;
- Legal cases relating to BR, specifically concerning the application of Tax Laws to companies in BR;
- Articles relating to BR, particularly the application of Tax Laws to companies in BR; and
- Other relevant Acts and legislation that may relate to the application of Tax Laws to companies in BR.

Throughout the dissertation information will be ranked and weighted, in terms of relevance and reliance, as follows:

- Acts and Legislation;
- Constitutional Court cases;
- Supreme Court cases;
- Income Tax Court cases;
- Alternative Dispute Resolution (“ADR”) rulings;
- Publications in a peer reviewed journal or book;
- Articles; and
- Discussion.

1.4. Limitations to scope

This dissertation is not intended to propose any changes or additions to current legislation in order to reduce the financial impact that Tax Laws may have on companies in BR. This dissertation merely seeks to understand the current legislation, how it is being applied, and how it may otherwise be applied.

Within SA legislation there currently exists numerous Acts that may infer either direct or indirect tax consequences on companies and accordingly companies in BR. While there is merit in exploring all of this legislation it is not feasible or practical for the scope of this dissertation. For this reason the direct taxes considered will be limited to the ITA and the indirect taxes considered will be limited to the VAT Act.

All references to the ITA in this dissertation refer to the Income Tax Act No 58 of 1962 including all changes made by the Taxation Amendment Act 43 of 2014.

All references to the VAT Act in this dissertation refer to the Value-Added Tax Act, Act No. 89 including all changes made by the Taxation Amendment Act 43 of 2014.

1.5. Structure of the dissertation

Given the nature of the research being conducted in this dissertation the focus will be primarily on gathering information and then analysing the information in an attempt to gain a better understanding of the current situation in the BR industry and/or identify new insights that have not been considered by those in the BR industry, specifically with reference to the financial impact that Tax Laws have on companies in BR.

Information will be gathered from several sources and areas in order to gain a fuller and more rounded view of the financial impact that Tax Laws have on companies in BR.

The dissertation will therefore follow the following structure:

- Chapter 2: The focus of this chapter will be on gaining an understanding of BR by reviewing and analysing the Companies Act. From this further sub-questions will be addressed, namely:
 - How has BR developed in SA;
 - What is BR;
 - When is BR applicable;
 - What is the BR process;
 - What happens to affected parties and company assets in BR; and
 - How is BR currently being applied in SA?

- Chapter 3: The focus of this chapter will be on gaining an understanding of how the Tax Laws currently impact companies in BR by reviewing and analysing tax legislation, legal cases and other relevant information. From this further sub-questions will be addressed, namely:
 - What provisions, if any, of the Tax Laws were amended or created to cater for BR;
 - What are the general tax consequences, based on 'average' BR plans, for companies in BR; and
 - What are the current problems faced in the BR industry with regard to the application of the Tax Laws?

- Chapter 4: The focus of this chapter is to identify what criteria one should consider when evaluating the financial impact of a decision and to determine, as far is possible, a single measurement tool. From this further sub-questions are addressed, namely:
 - What means of measurement does one use to evaluate the financial impact that the application the provisions of a Tax Law may have on a company;
 - Are all financial implications equal (for example a R100 loss of credit facilities compared to a R100 reduction in assessed losses); and
 - Is there any other criteria that one should consider when seeking to minimise the financial impact that a particular Tax Law provision may have on a company?

After a single measurement tool has been identified this is then applied to the tax impact created by the various BR strategies in order to assess their effect on the company.

- Chapter 5: The focus of this chapter is to identify any areas of the Tax Laws, as they apply to companies in BR, that have not been addressed in the previous chapters. This chapter therefore focuses primarily on fundamental issues and the deductibility of BR expenditure in terms of the general deduction formula.

- Chapter 6: This Chapter is the final chapter of the dissertation and forms the conclusion for the research performed.

2. Chapter 2: Understanding Business Rescue

2.1. Understanding BR in the context of the Companies Act

The first step in understanding the financial impact of the Tax Laws on BR is to gain an understanding of BR in the context of the Companies Act as this is the mechanism by which BR has been implemented into SA law.

Once a thorough understanding of BR and its key components in the context of the Companies Act and BR cases has been gained one can then identify and analyse the key provisions of the Tax Laws that are applicable to BR and the financial impact they have for companies in BR.

2.1.1. How has BR developed in SA?

On the 1st May 2011 the Companies Act was introduced into SA law and replaced The previous version of the Companies Act, the Companies Act No. 61 of 1973 (“Old Companies Act”). While there were several changes made to the Companies Act what is of particular relevance to this dissertation was the addition of BR into the Companies Act and SA law. The provisions of BR are dealt with in Chapter 6 of the Companies Act (S128 to S154).

While BR may have only been introduced into SA law in 2011 the SA basis for BR may be found in the Old Companies Act in Chapter 15 Judicial Management (S427 to S440).

Based on a reading of Chapter 15 of the Old Companies Act the following is applicable of Judicial Management:

- As per S427 Judicial Management was intended for companies that were unable to pay their debts, not performing successfully or to prevent a company from being wound up;
- A Company could only be placed under judicial management if an order was granted by the court, it was thus a ‘forced’ action upon a company;
- It was intended for the benefit of the creditors of the company rather than the collective stakeholders (it thus had a narrower scope than BR);
- As per S432(1) Judicial Management was for an initial period of 60 days, unless extended by the court (it was thus for a shorter period than BR);
- As per S430(a) and S433(a) the Judicial Manager took over the management of the company (Under BR the Directors are required to work with and support the BRP);
- As per S430(c)(vi) Judicial Management appears to have been an alternative to liquidation in so far as the Judicial Manager needed to determine whether there was any reason the company should not be liquidated; and

- Many of the provisions of Chapter 15 have references to and similarities with those contained in the Insolvency Act No. 24 of 1936 (“Insolvency Act”), including the powers vested in the Judicial Manager.

In practice Judicial Management orders were not often granted by the courts given the many years of legal precedent and narrow scope. When these orders were granted they generally did not result in a rescue of the company (Le Roux Hotel Management (Pty) Ltd and Another v E Rand (Pty) Ltd (FBC Fidelity Bank Ltd (Under Curatorship), 2001). Given the close connection that Judicial Management appears to have with liquidation, the narrow scope of its application, and its limited benefit (primarily for the creditors benefit) it makes sense that the courts would not often make use of Judicial Management over liquidation. Additionally Judicial Management was applicable for a company that was already in a financially dire position and unable to pay its debts rather than a company that was heading for or starting to show signs of financial distress. Judicial Management could perhaps thus be summed up as ‘Too little, too late’.

As will be discussed in further detail later in this Chapter, Chapter 6 of the Companies Act provided a stronger focus on the rescue and restoration of the company rather than being a ‘half-way house’ to liquidation that Judicial Management seems to have been.

The remainder of this section will focus on a statistical analysis of the progression of BR in SA.

As at the 23rd December 2014 there were 213 BR Practitioners (“BRP”) registered with the Companies and Intellectual Property Commission (“CIPC”). The highest concentration of BRP’s allocated in Gauteng (53%) followed by, Western Cape (19%), and Kwa-Zulu Natal (14%) (CIPC, 2014). The allocation of BRP’s therefore seems to correlate with the general economic activity in the country (CIPC, 2013).

The tables below reflect some of the statistics applicable to BR in SA.

Table 1: BR Proceedings status per year (CIPC, 2014)

Operational Business Rescue Proceeding Applications	2011	2012	2013	2014 (*)	2014 (**)	Total	Total Adj
Number of Business Rescue proceedings started	232	397	401	91	364	1,121	1,394
Business Rescue notices filed	305	500	439	94	376	1,338	1,620
Invalid filings and Nullity	73	103	38	3	12	217	226
Business Rescue Ended	100	145	99	5	20	349	364
Terminations of Business Rescue (COR 125.2)	38	60	39	4	16	141	153
Substantial implementation of Business Rescue (COR 125.3)	42	58	29	-	-	129	129
Liquidations	18	23	31	1	4	73	76
Business Rescue Set Aside	2	4	-	-	-	6	6
Active	132	252	302	86	344	772	1,030

* This relates to the period 01 January 2014 to 31 March 2014, an incomplete year

** This has been annualised, using 2014 as a base, in order to appropriate annual figures

Total adjusted includes the annualised 2014 figures

The BR notices filed over the period, detailed above, related to Private Companies (63%) and Close Corporations (31%). Public companies accounted for 5% of the total.

From Table 1 and information above the following is evident:

- The number of BR proceedings started has been on the increase since 2011. This is due to increases in the number of BR notices filed as well as fewer invalid filings (76% of filings in 2011 resulted in BR proceedings starting compared to 97% in 2014);
- On average 50% of BR proceedings ended were as a result of a notice by the BRP to terminate BR in accordance with S132(2)(b) of the Companies Act (it should be noted that this is not a clear indication that the BR proceedings have resulted in the successful rehabilitation of the company);
- BR proceedings ended as a result of a notice by the BRP to terminate accounted for 10.5% (9.4% of the Adjusted Total) of all BR notices issued;
- On average 28% of BR proceedings ended were as a result of a notice by the BRP that a substantial part of the BR plan has been implemented in accordance with S132(2)(c)(ii) of the Companies Act (it should be noted that this is not a clear indication that the BR proceedings have resulted in the successful rehabilitation of the company);
- BR proceedings ended as a result of a notice by the BRP that a substantial part of the BR plan has been implemented accounted for 9.6% (8.0% of the Adjusted Total) of all BR notices issued;
- On average 21% of BR proceedings ended were as a result of the company being put into liquidation in accordance with S132(2)(a)(ii) of the Companies Act; and
- On average 73% of BR proceedings started have not been resolved. 57% of the BR proceedings started in 2011 were still unresolved at the time the statistics were published (it should be noted that in accordance with S132(3) of the Companies Act, unless additional time is granted by the court, BR proceedings should not last more than three months).

Table 2: Number and type of BRP's registered per year and total registered (CIPC, 2014)

Type	2011	2012	2013	2014	Total
Experienced	21	32	20	8	81
Senior	44	21	7	1	73
Junior	5	10	16	28	59
Total	70	63	43	37	213

From Table 2 above it can be seen that there has been a decrease in the yearly number of registration of BRP's. This may be indicative to the industry starting to mature and stabilise, as well as CIPC becoming more discerning about the individuals

they appoint as BRP's. It should also be noted that the majority of BRP's registered are considered deemed to be very experienced.

Table 3: Composition of BRP by profession (CIPC, 2014)

Profession	No. of BRP's	% of Total
Attorney	87	41%
Accountant	55	26%
Consultant	28	13%
Chartered Accountant	25	12%
Entrepreneur / Director	7	3%
Liquidator	7	3%
Advocate	2	1%
Auditor	1	0%
General Tax Practitioner	1	0%
Total	213	100%

From Table 3 above it can be noted that Attorney's make up the single largest % of BRP's (41%), followed by Accountants (26%, 38% if combined with Chartered Accountants) and Consultants of various backgrounds (13%). 93% of all BRP's effectively come from 3 backgrounds: Legal, Financial and Consulting. These allocations are relatively consistent amongst the BRP types (Junior, Experienced, and Senior). This may be largely attributable to the Qualifications of practitioners required by the Commissioner as detailed in S138 of the Companies Act, particularly S138(1)(a) which requires that a BRP be a member in good standing of a legal, accounting or business management profession accredited by the Commission.

While, based on the information above one is not able to determine the practical business experience that the BRP's may have, it is clearly evident that an insignificant number of BRP's seem to be 'pure' entrepreneurs and business owners outside of their respective profession. Additionally given the fact that BR has not existed in SA before one needs to question how a BRP would be able to amass the +10 years of experience required to be registered as an experienced BRP.

One of the factors for the low success rate of BR may be attributable to the lack of 'rounded' BRP's (having financial, legal, management and practical experience). While a theoretical knowledge may be helpful to a business, a business will not 'work' based on theories alone; businesses need a practical 'operator' that can make things 'happen'. This is particularly relevant when one considers the complex nature of business and the multitude of specialised knowledge that is required to effectively manage all aspects of a business and different types of businesses. While a BRP may rely on the existing management for assistance this may not be enough given that the reason for the company entering into BR may be attributed to deficiencies in managements abilities.

2.1.2. What is BR?

Section 2.1.2 to 2.1.4 will focus on reviewing and analysing BR as laid down in the Companies Act.

BR is defined in S128(1)(b) of the Companies Act as follows: “business rescue” means proceedings to facilitate the rehabilitation of a company that is financially distressed by providing for –

- (i) the temporary supervision of the company, and of the management of its affairs, business and property;
- (ii) a temporary moratorium of the rights of claimants against the company or in respect of property in its possession; and
- (iii) the development of and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximises the likelihood of the company continuing in existence on a solvent basis or, if it is not possible for the company to so continue in existence, results in a better return for the company’s creditors or shareholders than would result from the immediate liquidation of the company.

Financially distressed is defined in S128(1)(f) of the Companies Act as follows: “financially distressed”, in reference to a particular company at any particular time, means that—

- (i) it appears to be reasonably unlikely that the company will be able to pay all of its debts as they become due and payable within the immediately ensuing six months [commercial insolvency]; or
- (ii) it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months [factual insolvency].

Solvency and Liquidity are not defined in the Companies Act, however, Section 4 of the Companies Act details a solvency and liquidity test as follows—

- (1) For any purpose of this Act, a company satisfies the solvency and liquidity test at a particular time if, considering all reasonably foreseeable financial circumstances of the company at that time—
 - (a) the assets of the company, as fairly valued, equal or exceed the liabilities of the company, as fairly valued;

The last important definition to consider is what it means to rescue the company. “Rescuing the Company” is defined in S128(1)(h) as achieving the goals set out in the definition of “business rescue” in S128(1)(b).

BR can thus be broken into the following key points:

- **Rehabilitation** of a **financially distressed** (as defined) company which includes:
 - The **temporary supervision** of the **company** (in its entirety);
 - A **temporary moratorium** of the **rights** of claimants; and
 - The **development and implementation** of a **BR plan**.

2.1.3. What is the main objective of BR and when is it applicable?

Following on from 2.1.1 above we are able to identify that the main purpose of BR as per the Companies Act is to rehabilitate a financially distressed company, or if it is not possible to rehabilitate the company to provide a better return for the company's creditors and shareholders than would result from the immediate liquidation of the company.

This is emphasised by S7(k) of the Companies Act which states that one of the purposes of the Companies Act is to provide for the efficient rescue and recovery of financially distressed companies, in a manner that balances the rights and interests of all relevant stakeholders.

In order to achieve this result, BR caters for the restructuring of the company's affairs, business, property, debt and other liabilities, and equity.

In order for a company to enter into BR the company must:

- Be **financially distressed**;
- Must have a **reasonable prospect of being rescued (rehabilitated)**; and
- **Not** have had **liquidation proceedings** initiated by or against it.

Rehabilitation is not defined in the Companies Act despite this being a core concept of BR. It therefore stands to reason that the dictionary definition for rehabilitation should be used to define this concept:

Re·ha·bil·i·tate (Houghton Mifflin Company, 2009)

1. To restore to good health or useful life, as through therapy and education.
2. To restore to good condition, operation, or capacity.
3. To reinstate the good name of.
4. To restore the former rank, privileges, or rights of.

From the definition above it appears evident that the concept of BR is thus to 'restore' the company to good condition, operation, or capacity as well as ensure that the company is able to regain its former rank, privileges and rights. Ultimately BR should reinstate the good name of the company, i.e. the company should be seen

as credible and reliable post-BR so that the company may enjoy the same benefits and operations that it had prior to its financial distress.

This definition may also be used to assist in determining when BR is applicable, specifically what is 'a reasonable prospect of being rescued'. It stands to reason that the company would have had to have been in some form of good condition prior to BR otherwise one would not be able to rehabilitate or restore the company. In its strictest definition it would therefore imply that BR should only be available to companies that at one point or another:

- Had a good name (seen as credible and reliable in industry and the market);
- Have a trading history;
- Have been profitable and been capable of positive cash generation; and
- Have the necessary operating base or assets to restore (for example if the reason for financial distress is due to having disposed of or lost key cash generating assets then it is unlikely that one could restore the operations of the company without these assets).

While the points above may indicate that the company at one point was financially sound, one also needs to understand 'what went wrong' in order to assess whether a rehabilitation is possible.

A company that was financially sound and is now financially distressed may become so for one or more of the following reasons (at a high level consideration):

- Changes in the market place, including:
 - Decreased demand for the company's products and services which leads to loss of revenue;
 - Inability to source products reliably either due to supplier problems or cash flow constraints;
 - Cheaper substitute products and services entering the market and the company no longer being able to compete effectively;
 - Changes in laws and regulations related to the company that may add to the cost or desirability of the company's products;
- Prolonged shut down periods due to labour problems;
- Company costs ramping up due to input costs increases (foreign exchange appreciation, labour price increases, etc.);
- Changes in supplier or financiers lending terms;
- Debtors defaulting on payments;
- Bad management;
- Bad cost management; and
- Inability to 'change with the times', i.e. ineffective with the design and implementation of effective business strategies.

While this is not an exhaustive list, it is clear that some of these issues are pervasive and perhaps irreparable. Some are completely out of the company's control (such as labour strikes), while others are less severe and more temporary in nature (such as a debtor defaulting on payment), however, all of these issues have an impact on the company's financial well-being.

It therefore stands to reason that the only feasible way to rehabilitate a company is to ensure that it is able to improve its financial well-being by addressing the cause of the financial distress or finding a way for the company to overcome the financial distress.

The direct and indirect taxes payable by the company therefore play a part in the possible rehabilitation of the company given that they have a financial impact on the company.

2.1.4. What is the BR process?

The BR proceedings are dealt with in Part A (S128 to 137) of Chapter 6 of the Companies Act. This section provides a description of the BR proceedings and process as well as an analysis on some of these provisions.

A company can begin BR proceedings in one of two ways, namely:

- (1) Voluntarily - through a company resolution (Defined in S129 of the Companies Act); or
- (2) Involuntarily - through a court order initiated by an affected person of the company (Defined in S131 of the Companies Act).
 - Affected person in relation to the company is defined in S128(a) as:
 - i. A shareholder or creditor of the company;
 - ii. Any registered trade union representing employees of the company; and
 - iii. If any of the employees of the company are not represented by a registered trade union, each of those employees and their respective representatives.

It should be noted that, as per S129(2)(a) and S131(8)(a) of the Companies Act, a company cannot voluntarily enter into BR if liquidation proceedings have been initiated by or against the company. In terms of S130(5)(c)(i) of the Companies Act the court may, based on appropriate considerations, issue an order placing a company that is in BR into liquidation. Additionally, as per S131(6) of the Companies Act, the court may, based on appropriate considerations, suspend liquidation proceedings and instead put the company in BR.

It is therefore evident that while some similarities may exist between BR and liquidation they are succinctly different in nature, administration and form. BR is also distinctly different from Judicial Management and the way it was applied.

The process, as per the Companies Act, whereby a company voluntarily enters into BR are detailed as follows:

Initiation

- S129(1) The board of the company resolves to enter into BR proceedings having taken into account that the company is:
 - 129(1)(a) Financially distressed
 - 129(1)(b) Has reasonable prospect of rescue

Exceptions

- S129(2)(a) Cannot be adopted if liquidation proceedings have been initiated
- S129(2)(b) Resolutions have no force or effect until filed with CIPC

Notifications and appointments

- S129(3) Within 5 days of adoption and filing for BR the company must:
 - S129(3)(a) publish a notice of the resolution to each affected person
 - S129(3)(b) Appoint a BRP who satisfies the requirements of S138
- Subsequent to the appointment of the BRP the company must:
 - S129(4)(a) Within 2 days file a notice with CIPC
 - S129(4)(b) Within 5 days publish a notice of to each affected person
- If these provisions are not followed:
 - S129(5)(a) The BR resolution lapses and is a nullity
 - S129(5)(b) Cannot file for BR for three months

Objections

S130(1) Subject to the adoption of the BR resolution in terms of S129 and until the adoption of the BR plan an affected party may apply to the court for an order to:

- S130(1) (a) set aside the resolution;
- S130(1) (b) set aside the appointment of the BRP; or
- S130(1) (c) require the BRP to provide security for the company or any affected persons.

It should be noted that an objection to the BR can only take place when a company voluntarily enters into BR.

What should be considered with voluntary BR (S129) is that this process is initiated by the existing management of the company. Further, assuming no objections are

made by affected parties, management may therefore be able to impact the BR process, and potentially the outcome, by selecting the BRP. Given managements fiduciary duties, in terms of the Companies Act, it stands to reason that voluntary BR would be initiated for the best interests of the company and its various stakeholders.

The process, as per the Companies Act, whereby a company involuntarily enters into BR are detailed as follows:

Initiation

- S131(1) An affected person may apply to a court at any time for an order to place the company into BR

Notifications

- S131(2) The applicant (affected person) must:
 - S131(2)(a) serve a copy of the application on the company and CIPC
 - S131(2)(b) notify each affected person of the application in the prescribed manner

Court order

- S131(4) After considering the application the court may:
 - S131(4)(a) Place the company in BR; or
 - S131(4)(b) Dismiss the application
- S131(5) The court may also appoint a BRP that satisfies the requirements of S138, and who has been nominated by the affected person who applied for the order. This application is subject to ratification by the holders of a majority of the independent creditors voting interests.
- S131(6) If liquidation proceedings had commenced against the company at the time of the court application, the liquidation proceedings may be suspended until:
 - The court has adjudicated upon the application; or
 - The BR proceedings end.

What should be considered with involuntary BR (S131) is that this process is initiated by an affected person of the company. Further, assuming ratification by the independent creditors, the affected person may therefore be able to impact the BR process, and potentially the outcome, by selecting the BRP. Given the personal cost and time the affected person would need to spend on initiating BR it stands to reason that involuntary BR would be initiated for the best interests of the affected person and not necessarily the company and its various stakeholders.

It may therefore be argued that the process by which a company enters BR may have a direct impact on the potential success of the BR and the ultimate outcome to the various stakeholders.

Despite the way in which a company enters into BR the remainder of the provisions of the Companies Act apply to both forms of BR, namely voluntary and involuntary BR.

The duration of BR proceedings is detailed in S132 of the Companies Act. This is detailed below.

Initiation

As per S132(1) BR proceedings begin when —

- the company—
 - files a resolution to place itself under supervision in terms of S129(3); or
 - applies to the court for consent to file a resolution in terms of S129(5)(b);
 - an affected person applies to the court for an order placing the company under supervision in terms of S131(1); or
- a court makes an order placing a company under supervision during the course of liquidation proceedings, or proceedings to enforce a security interest, as contemplated in S131(7).

Time period

As per S132(3) the standard time frame for BR is three months. This period can be extended only by an order granted by the court.

Termination

BR proceedings end when:

- the court—
 - sets aside the resolution or order that began those proceedings; or
 - has converted the proceedings to liquidation proceedings;
- the practitioner has filed with the Commission a notice of the termination of BR proceedings; or
- a BR plan has been—
 - proposed and rejected in terms of Part D of Chapter 6 of the Companies Act, and no affected person has acted to extend the proceedings; or

- adopted in terms of Part D of Chapter 6 of the Companies Act, and the practitioner has subsequently filed a notice of substantial implementation of that plan.

The following should be considered with regards to the duration of BR:

- BR is designed for companies that are in financial distress which is defined in S128(1)(f) of the Companies Act as a company that:
 - is reasonably likely to become commercially insolvent in the ensuing 6 months; or
 - is reasonably likely to become factual insolvent in the ensuing 6 months.

One therefore needs to consider why the standard duration of BR would be for three months if the financial distress that the company is in may cause it to not be able to 'survive' beyond the ensuing 6 months. It stands to reason that for a BRP to ensure that the company is able to overcome the financial distress the BRP would need to assist the company through at least 6 months;

- The only way for a company to increase the duration of BR is through a court order. This represents an additional complicated administrative, financial and time burden for a company that already cannot afford delays or to waste the limited funds they may have;
- Given the large number of active BR cases compared to those initiated, as detailed in Section 2.1.1 above, it is evident that the vast majority of companies will need a BR duration of more than the standard three months;
- BR can be terminated at any time for any reason by the BRP (S132(2)(b)). It therefore stands to reason that there is no reason for the standard BR duration to have to be 3 months. If the BRP does not need the full time allowed they may end the process sooner. If the Commissioner is concerned that the BRP's will abuse the time frame then this should be addressed through penalties and fines to the BRP rather than at a cost to the company as it currently is;
- Financial planning is typically split into three distinct time periods: short term (1 to 2 years), medium term (3 to 5 Years), and long term (more than 5 years). It is therefore evident that given the standard duration of BR the focus is on the extreme short-term and would therefore not encourage the BRP to consider or plan for the medium-term to long-term future of the business; and
- BR can end without any solution or agreement having been reached to enable the company to overcome its financial distress. In such a situation the company would have most likely have expended significant amounts of time and money thus putting the company in even more dire financial distress. In

such a situation the logical next step for such a company would be liquidation.

The standard BR period of three months does not seem to be an adequate period for rehabilitating a company and enabling it to overcome its financial distress. Added to this the standard BR period can only be extended by the granting of a court order which adds to the complexity and cost of BR. Another implied consequence of the short duration of the BR period is that it may force BRP's to adopt short-term decision making and design BR plans that are short-term in nature; plans that yield immediate results rather than focus on the long-term well-being of the company. All of these factors would ultimately increase the burden for the company trying to overcome financial distress and decrease the possibility of rehabilitation.

2.1.5. What happens to affected parties and company assets in BR?

General

An integral part to BR is to provide the company with 'breathing room' to assess the current business situation and then to design and implement a plan to rescue the company. One of the ways that BR creates the required 'breathing room' is through S133 of the Companies Act.

S133 provides for a general moratorium on legal proceedings against a company while in BR. While the company is in BR no legal proceeding, including enforcement action, against the company, or in relation to any property belonging to the company, or lawfully in its possession, may be commenced or proceeded with in any form. This includes the enforcement of any guarantee or surety that the company may have given.

Further to this, in the situation where any right to commence proceedings or otherwise assert a claim against the company is subject to a time limit, this time limit is suspended during the company's BR proceedings.

Exceptions to the general moratorium are included in S133, however, they require the written consent of the BRP or some form of legal or regulatory ruling. Thus they would not generally be appealing to an affected party due to the difficulty or cost required to enact the exceptions.

Part C of Chapter 6 of the Companies Act (S144 to S149) deals with the specific rights granted to affected persons during BR. Based on Part C and the definition of an affected person as per S128(a) of the Companies Act, BR considers the following types of individuals to be affected parties:

- Employees (including any trade union representing employees);

- Creditors; and
- Holders of the company's securities.

Rights of employees (S144 of the Companies Act):

As per S144(5) of the Companies Act the rights of employees are in no way reduced or diminished as a result of BR but rather added to.

In addition to an employee's normal rights the following additional rights are granted to them, in terms of S144(3) of the Companies Act, while the company is in BR, they have a right to:

- Notice, which must be given in the prescribed manner and, of each court proceeding, decision, meeting or other relevant event concerning the BR proceedings;
- Participate in any court proceedings arising during the BR proceedings;
- Form a committee of employees' representatives;
- Be consulted by the practitioner during the development of the BR plan, and afforded sufficient opportunity to review any such plan;
- Be present and make a submission to the meeting of the holders of voting interests before a vote is taken on any proposed BR plan;
- Vote with creditors on a motion to approve a proposed business plan, to the extent that the employee is a creditor; and
- If the proposed BR plan is rejected, to—
 - Propose the development of an alternative plan; or
 - Present an offer to acquire the interests of one or more affected persons.

What should be noted is that as per S144(2) of the Companies Act if any money is owed to an employee, and has not been paid to that employee, immediately before the beginning of the BR proceedings then that employee will be treated as a preferred unsecured creditor for the purposes of BR.

In addition to this, as per S144(4) of the Companies Act, a medical or pension scheme will be treated as an unsecured creditor to the extent that amounts due and payable, for the benefit of past and present employees, have not been paid over by the company to the respective scheme.

Rights of Creditors (S145 of the Companies Act)

Through BR some of the rights of creditors are enhanced while others are restricted or limited. Each creditor has the right to:

- Notice of each court proceeding, decision, meeting or other relevant event concerning the BR proceedings;
- Participate in any court proceedings arising during the BR proceedings;

- Formally participate in a company's BR proceedings to the extent provided for in Chapter 6 of the Companies Act;
- Informally participate in those proceedings by making proposals for a BR plan to the practitioner;
- To form a creditors' committee, and through that committee are entitled to be consulted by the practitioner during the development of the BR plan;
- The right to vote to amend, approve or reject a proposed BR plan; and
- If the proposed BR plan is rejected, to—
 - Propose the development of an alternative plan; or
 - Present an offer to acquire the interests of one or more affected persons

What is relevant to note for creditors is that the majority of their rights are linked or otherwise determined with reference to the extent of their voting interest. A creditors voting interest is determined in the following way as per S145(4) of the Companies Act:

- A secured or unsecured creditor has a voting interest equal to the value of the amount owed to that creditor by the company; and
- A concurrent creditor who would be subordinated in a liquidation has a voting interest, as independently and expertly appraised and valued at the request of the BRP, equal to the amount, if any, that the creditor could reasonably expect to receive in such a liquidation of the company.

Rights of holders of the company's securities (S146 of the Companies Act)

The rights of the holders of the company's securities are made to be somewhat more restrictive, however, some rights are enhanced to allow the holders of the company's securities to become more actively involved in the decision making of the business. Each holder of the company's securities has the right to:

- Notice of each court proceeding, decision, meeting or other relevant event concerning the BR proceedings;
- Participate in any court proceedings arising during the BR proceedings;
- Formally participate in a company's BR proceedings to the extent provided for in Chapter 6 of the Companies Act;
- Vote to approve or reject a proposed BR plan if the plan would alter the rights associated with the class of securities held by that person; and
- If the proposed BR plan is rejected, to—
 - Propose the development of an alternative plan; or
 - Present an offer to acquire the interests of one or more affected persons

Post-commencement finance (S135 of the Companies Act)

What has become a controversial issue in BR is the concept of Post-commencement finance, particularly for SARS (the specifics of this will be dealt with later in the dissertation). S135 details the preference with which claims, incurred while the company is in BR, are to be paid out including the preference they receive over claims that existed prior to BR. In terms of S135 claims are treated with the following preference:

1. BRP's remuneration and expenses (As per S143 of the Companies Act) and other claims arising out of the costs of the business rescue proceedings;
2. Any amount due and payable to an employee in connection with their employment, while the company has been in BR, that has not been paid;
3. Any amounts due to secured creditors incurred prior to BR;
4. Any amounts due to an employee in connection with their employment, before the company was placed in BR, that has not been paid;
5. Any amounts due to secured creditors incurred post-BR (such claims are payable in the order in which they were incurred);
6. Any amounts due to unsecured creditors incurred post-BR (such claims are payable in the order in which they were incurred);
7. Any amounts due to unsecured creditors incurred prior to BR; and
8. Any amounts due to concurrent creditors.

Impact on Company assets

Chapter 6 of the Companies Act does not make any specific reference to what protection is afforded for the assets of the company other than in S134 which deals with the property interests of the company.

S134 of the Companies Act seeks to limit the way a company can dispose of property to:

- The ordinary course of its business (it is assumed to be intended for companies that hold property as trading stock);
- A bona fide transaction at arm's length for fair value approved in advance and in writing by the practitioner; or
- A transaction contemplated within, and undertaken as part of the implementation of, a BR plan.

Further to this S134(1)(c) of the Companies Act seeks to limit the ability of any person to exercise any right they may have to any property legally in the possession of the company, irrespective of whether the property is owned by the company.

The last aspect that should be considered with reference to the company's assets is that BR grants the company some additional compliance exceptions that would

otherwise not be allowed. This is particularly relevant to Chapter 5 of the Companies Act – Fundamental transactions, takeovers and offers.

Chapter 5 of the Companies Act is concerned primarily with fundamental transactions such as a:

- Proposals to dispose of all or a greater part of the company assets;
- Proposals for an amalgamation or merger of the company; and
- Proposals for a scheme of arrangement between the company and holders of any class of its securities.

In terms of Chapter 5 of the Companies Act a company normally requires approval from the Takeover Regulations Panel (“TRP”) before they can proceed with a fundamental transaction, however, this is not the case if the fundamental transaction is conducted in accordance with a BR plan.

It is assumed that the reason that these exceptions exist is due to the transparency with and agreement required by the affected parties (particularly the creditors) of the company in order to enact any fundamental transaction. The purpose of the TRP is to protect creditors and the security holders of the company therefore if they are involved in the decision it is assumed that they would be making an informed and intentional decision thus there would be no need for TRP approval.

Overall it appears BR has the following impact on the rights of affected parties:

- Some rights are reduced:
 - General moratorium on legal proceedings against the company (including enforcing of any guarantees and sureties);
 - Limited ability to remove the company from any property they may occupy (it is assumed this applies to financial institutions and landlords); and
 - The ability to act ‘alone’. An approved BR plan that is voted for by 75% of the creditors (as determined by voting rights) cannot be rejected by any other party including SARS.
- Some rights are enhanced:
 - Affected parties are given increased transparency of the business by having access to information that they may otherwise not have been able to get or get as easily;
 - Affected parties are given an input into the future of the company by having an influence in the BR plan (although it is the creditors that ultimately need to approve the plan);
 - The company is given the ability to make some fundamental changes to the company quickly (Exempt from Chapter 5 of Companies Act

provisions) and perhaps more effectively by having a larger group buy-in (all affected parties can contribute to the BR plan).

While BR may consider a wider base than that of Judicial Management, BR still grants the creditors of the company the most 'power' as the creditors are ultimately the ones that decide on the future of the company by either accepting or refusing the BR plan.

The impact of this will no doubt depend on who the majority of the creditors are but it stands to reason that the bigger institutions such as SARS and the financial institutions may rather opt for liquidation over BR given the quicker access they will have to funds and the preferential claims they would enjoy under these scenarios. This is particularly true for SARS who is seen as a preferential creditor in liquidation scenarios (As per S99 of the Insolvency Act) but not under BR.

2.2. How is BR currently being applied in SA?

The focus of this Section will to review and analyse completed BR plans in order to gain an understanding of how Chapter 6 of the Companies Act (BR) is being applied in industry by BRP's. Of particular relevance will be the financial impact of Tax Laws on the Company and whether these were even taken into account by the BRP. Further to this the BR plan will be analysed to determine the nature of the strategy adopted, short-term versus long-term.

1. **Case 1: Resource Ballast Technologies (Propriety) Limited¹**

1.1. **Nature of BR:** Voluntary BR (Resolution passed on 3 February 2012)

1.2. **BR plan date:** 19 July 2012

1.3. **Company formation date:** 2001 (still considered a start-up as pre-revenue generation)

1.4. **Industry:** Technology development in water treatment

1.5. **Company size:** Small

1.6. **Reason for financial distress:**

1.6.1. The Company experienced delays in the industrialisation and certification of products;

1.6.2. Was unable to recapitalise the company; and

1.6.3. When investor loans were due and payable no funds were available to pay these and the company filed for BR.

1.7. **Time frame of BR plan:** 3 years (includes further product development, product industrialisation and product commercialisation).

¹ As the Business Rescue process has come to an end all BR plans have been removed and are no longer available at the original source.

1.8. Key aspects of BR plan:

To successfully emerge from BR (Short-term)

- 1.8.1. Capital raise of R6.8 million from existing investors;
- 1.8.2. Convert existing preference shares to equity (preference shareholders to exercise their options);
- 1.8.3. Prove the commercial viability of the company's technology (Envisioned to be a 9-month process costing approximately R5 million);

To become commercially successful (Long-term)

- 1.8.4. Compromise with a creditor to the value of R8.9m;
- 1.8.5. Additional capital raising of R45.5 million from new investors;
- 1.8.6. Build capacity either in-house or by finding strategic partners to assist with this; and
- 1.8.7. Maintain competitive advantage through on-going product development and strategic competitive positioning.

1.9. Financial impact of Tax Laws:

- 1.9.1. No consideration given to the tax implication of BR plan; and
- 1.9.2. Based on the key aspects of the BR plan it appears that the most significant tax implication would arise from the potential compromise with a creditor (R8.9m compromise).

The tax implications of this will be dealt with in Chapter 3 below.

- 1.10. **Other:** BRP treated SARS as a statutory preferential Creditor, however, this interpretation does not appear to exist in terms of Chapter 6 of the Companies Act. SARS claim appears to have resulted from non-payment of Pay-as-you-earn tax ("PAYE") (indirect tax) prior to BR.
- 1.11. **Outcome:** Company ultimately liquidated

2. Case 2: Thuthuka Group Limited²

- 2.1. **Nature of BR:** Voluntary BR (Resolution passed on 6 November 2013)
- 2.2. **BR plan date:** 28 February 2014
- 2.3. **Company formation date:** 2005
- 2.4. **Industry:** Engineering focusing on industrial water, hazardous waste and air pollution control
- 2.5. **Company size:** Large
- 2.6. **Reason for financial distress:**
 - 2.6.1. The company was engaged in a number of projects which were bid at low margins and resulted in losses and negative cash flow;

² As the Business Rescue process has come to an end all BR plans have been removed and are no longer available at the original source.

- 2.6.2. Large amounts of infrastructure spending occurred prior to 2010, this spending subsequently reduced post 2010 with the company receiving fewer new projects;
- 2.6.3. Company overheads became too high relative to revenue which resulted in losses to the company;
- 2.6.4. Project revenues were ceded to suppliers in order to cover supplier debts;
- 2.6.5. Available cash was spent on settling existing debts rather than completing revenue generating projects;
- 2.6.6. Cash flow constraints led to delays in completing projects which lead to penalties being levied and further losses for the company; and
- 2.6.7. Unable to recapitalise the business through selling key assets.
- 2.7. **Time frame of BR plan:** Not specified – taken to be the time that it takes to dispose of the company assets
- 2.8. **Key aspects of BR plan:**
 - Due to key proposals made being rejected the BRP decided the company could not be rescued, the BR plan was therefore based on trying to provide the best possible return for creditors;
 - 2.8.1. All permanent and temporary staff were retrenched;
 - 2.8.2. All existing projects were suspended due to not being able to renegotiate better terms and the risk of further losses (BR plan assumes that these projects will all ultimately be cancelled);
 - 2.8.3. Sale of the Industrial division of the company (Profitable subsidiaries not forming part of the core business of the company);
 - 2.8.4. Sale of the company's fixed assets; and
 - 2.8.5. Remaining proceeds from the sale of the industrial division and assets to be used to settle creditors in order of their preference.
- 2.9. **Financial impact of Tax Laws:**
 - 2.9.1. No consideration given to the tax implication of BR plan;
 - 2.9.2. Capital Gains tax may be applicable depending on the value of assets disposed of relative to their base cost; and
 - 2.9.3. There was a compromise with creditors given that settlement of outstanding claims would be a partial settlement and would be a full and final settlement.

The tax implications of these will be dealt with in Chapter 3 below.

- 2.10. **Other:**
 - 2.10.1. Ultimate holding company is a Mauritian company;
 - 2.10.2. Ultimate holding company placed into liquidation prior to subsidiary going into BR;

- 2.10.3. BRP specifically made reference to any prospective claim which SARS may have against the Company, under section 22(3) of the VAT Act or otherwise, will be compromised under and in terms of the BR plan (thereby including SARS with other concurrent creditors);
- 2.11. **Outcome:** Company ultimately liquidated

3. Case 3: Blythedale Coastal Resort (Proprietary) Limited³

- 3.1. **Nature of BR:** Involuntary BR (Court order granted on 27 September 2013)
- 3.2. **BR plan date:** 15 July 2014
- 3.3. **Company formation date:** 2005
- 3.4. **Industry:** Property Development (Lands Claims Development JV)
- 3.5. **Company size:** Medium
- 3.6. **Reason for financial distress:**
- 3.6.1. Land given to the community as part of a land reform claim;
 - 3.6.2. Community entered into a JV whereby the land would be developed and they would receive a 20% shareholding in the development company and other auxiliary benefits;
 - 3.6.3. Remaining shareholder was to raise finance and develop the land;
 - 3.6.4. Developer tried to register a bond over the land and the community refused to allow this;
 - 3.6.5. Developer was not able to raise funds to develop the land;
 - 3.6.6. The community claimed that they were not benefiting as the land was not being developed and put an order together to get the land back from the company; and
 - 3.6.7. The community ultimately won and the company had to transfer the property (sole asset) back to the community on payment of a fee by government.
- 3.7. **Time frame of BR plan:** Not specified – taken to be to the extent creditor claims are settled through dividend payment
- 3.8. **Key aspects of BR plan:**
- Company not able to be rescued
- 3.8.1. Through legal proceedings the company received cash of R322 million in exchange for its sole asset (land);
 - 3.8.2. Cash received will be used for provisions for future legal claims against the company (if any); and
 - 3.8.3. Remaining cash paid to creditors in terms of their preferential claims.
- 3.9. **Financial impact of Tax Laws:**
- 3.9.1. No consideration given to the tax implication of BR plan.

³ As the Business Rescue process has come to an end all BR plans have been removed and are no longer available at the original source.

- 3.9.2. Capital Gains tax may be applicable depending on the value of assets disposed of relative to their base cost; and
- 3.9.3. There was a compromise with creditors given that settlement of outstanding claims would be a partial settlement and would be a full and final settlement.

The tax implications of these will be dealt with in Chapter 3 below

3.10. Other:

- 3.10.1. BR initiated by minority (20%) shareholder of the development JV;
- 3.10.2. Company was in legal proceedings before and during the BR proceedings over the land owned by the company (the sole asset of the company);
- 3.10.3. BRP identified the inherent difficulties in dealing with creditors' claims under the Companies Act, particularly with reference to creditors proving claims; and
- 3.10.4. BRP's claim for not liquidating the company was that he believed that liquidation would take a longer time to wind up than BR which would result in a lesser dividend to creditors.

3.11. Outcome: Company shares transferred to minority shareholder (land holder)

While the sample of BR cases selected was relatively small the cases above are still useful for us to begin to understand how BR is being applied in industry.

From the cases reviewed above it appears that none of the cases were able to successfully rescue the company. This is most likely attributable to the fact that of the three cases above it appears that only one of the companies was ever a going concern (Case 2: Thuthuka Group Limited). It therefore stands to reason that the other two companies could not be rehabilitated (as defined and discussed earlier in this Chapter) as there was nothing to rehabilitate.

S150(2)(c)(iv) of the Companies Act requires that the BRP provide a three-year financial forecast (balance sheet and income statement) for the company. What was evident from the cases above, and may be a symptom of the situation of the companies above, is that the BR plan strategies focused primarily on the short-term hurdle of the company, namely to raise enough funds to enable the company to move past BR. What was found from review of the three-year forecasts was that there was not much emphasis put on the later periods (years 2 and 3) or what was required to get the companies past BR. The forecast periods were therefore fairly arbitrary or irrelevant given the ultimate BR plan.

Based on the review of the BR plans it was also evident, from the cases above, that none of the BR plans took into account the possible tax consequences, if any, that the BR plan would have on the company.

It is also worth noting the varied approach and nature to the BR plans prepared by each BRP. The Companies Act prescribes the minimum information that must be contained in a BR plan there is no guidance provided on how the BR plan should be presented or what approach one should follow through the development of the BR plan. It is fair to say that how one should approach BR is outside the scope of the Companies Act, however, this does not necessarily imply that there should not be some form of prescribed standard or approach. As with international accounting standards the onus of developing such standards or approach would need to come from those in industry. In the absence of unified and specific governing body for BRP's it is unlikely that any such standards or approach will ever be developed.

3. Chapter 3: Understanding the application of the Tax Laws

The focus of this chapter will be on gaining an understanding of how the Tax Laws currently impact companies in BR by reviewing and analysing tax legislation, legal cases and other relevant information.

Given the short length of time that BR has been in SA there is currently very little case law, and consequently legal precedent, pertaining to BR and companies in BR. For this reason, more focus will need to be applied to the existing tax legislation and how it may be applied to companies in BR, including what ambiguities may exist in such application.

3.1. Understanding BR in the context of the Tax Laws

The financial impact of the Tax Laws will firstly focus on the ITA and the Vat Act. The both the ITA and the Vat Act are fairly extensive and applicable to companies both in and out of BR. As far as possible dissertation will focus on the financial impact of the Tax Laws are for companies in BR; as such the general application of the ITA and Vat act will not be dealt with but rather the specific consequences that may be applicable to a company that is in BR (if such vivisection is possible).

3.1.1. Tax Laws amended or created to cater for BR

In order to understand what the specific financial consequences the Tax Laws may have for a company in BR, one must first understand if any of the provisions in the legislation were amended or created to cater for BR. The primary source of information for determining this will be the Explanatory Memorandum on the Taxation Laws Amendment Bills ("Explanatory Memorandum") and Taxation Laws Amendment Bill ("Amendment Bill") 2008 to 2015. This review will be limited to:

- Income tax applicable to businesses; and
- VAT.

The reason for limiting the review to these taxes is because they tend to have the most impact on a company and tend to be sufficiently complex that they may need amendment or addition to cater for changes in company laws.

The 2010 Explanatory Memorandum is the first Explanatory Memorandum that makes reference to the changes in company legislation, namely the introduction of the Companies Act and with it BR proceedings. The 2010 Explanatory Memorandum further states that as a result of these changes there was a need to make amendments to the ITA in order to align the ITA with the changes in companies' law principles. No such mention was made about having to amend the VAT Act to cater for changes in the Companies Act.

The majority of the changes and inclusions made to the ITA by the 2010 Amendment Bill, as a result of the changes in company law principles, pertain to changes in the definitions and wording of the ITA to align with the definitions and wording of the

Companies Act. Further amendments were made to cater for changes to the taxation of dividends and distributions by companies.

While the changes made to the ITA and Vat Act may have an impact on companies in BR, none of the changes made as part of the 2010 Amendment Bill to tax legislation appear to have been made to cater specifically for BR. The same is true of the 2011, 2013 and 2014 Amendment Bill.

Based on a review of the 2012 Explanatory Memorandum, the 2012 Amendment Bill appears to be the first and only Amendment Bill that created provisions to cater for BR, despite not specifically targeting companies in BR. The changes made relate specifically to the debt definition and the reduction of debt for less than full consideration (“Debt Relief”).

It should be noted that Part E of Chapter 6 of the Companies Act (S155) focuses on compromise with creditors but, as with the ITA, does not limit the application of Part E to companies in financial distress as defined in S128(1)(f) of the Companies Act.

The 2012 Explanatory Memorandum highlighted the importance that the definition of ‘debt’ has in terms of defining how a transaction is to be treated under the ITA. For this reason the definition of ‘debt’ in the ITA was changed, to bear its ordinary meaning, in order to unify the various concepts and terms involving debt in the ITA. It was hoped that the change in the ‘debt’ definition would remove any inconsistencies and uncertainties that may have existed in the ITA as a result of the various concepts and terms previously used. It should be noted, however, that S19 and Paragraph 12A of the Eighth Schedule of the ITA specifically excludes tax debt as defined in section 1 of the Tax Administration Act from the definition of debt in the ITA.

The 2012 Explanatory Memorandum also highlighted the fact that the global financial crisis had created a situation where a large number of companies were experiencing financial distress and that relief for these companies was essential for the recovery of the economy. Further to this it was also noted that the tax system, as it was, created additional problems for companies in financial distress, particularly the parties receiving relief from debt (this was true even in situations where SARS was the one granting the relief in terms of tax debt forgiven).

The tax treatment of Debt Relief has always been determined with reference to the underlying cause of the reduction. The tax treatment of Debt Relief is determined by characterising the debt as one or more of the following:

- Ordinary income;
- Capital gain;
- Donation; or
- Estate transfer.

Of the above treatments ordinary income and capital gains are of the most relevance to a company in BR.

Prior to the 2012 Amendment Bill Debt Relief for a company was dealt with in the following way:

- Ordinary income – If the debt was originally utilised to fund expenditure or an allowance asset and a deduction or allowance was previously granted then;
 - The company's assessed loss was reduced to the extent of the debt relief given (previously S20 of the ITA); and/or
 - The company will be subject to a recoupment to the extent of the debt relief given (previously S8(4)(a) and (m) of the ITA).
- Capital gains – This applies in the event that the debt relief did not give rise to ordinary income (as detailed above). If the Debt Relief is granted for debt that was:
 - originally used for the acquisition of a capital asset and:
 - the asset is still held by the debtor then the base cost of the capital asset is reduced to the extent of the debt relief granted (paragraph 3(b)(ii) of the Eighth Schedule of the ITA); or
 - the asset is no longer held by the debtor then a capital gain is realised to the extent of the debt relief granted (paragraph 12(5) of the Eighth Schedule to the ITA);
 - not attributable to the acquisition of a capital asset then a capital gain is realised to the extent of the Debt Relief granted (paragraph 12(5) of the Eighth Schedule to the ITA), except if (paragraph 56(2) of the Eighth Schedule of the ITA):
 - the debtor and creditor are part of the same group of companies; or
 - the debtor is being liquidated and the creditor is a connected person (in such case the connected person would be denied a claim for the loss).

The 2012 Amendment Bill sought to provide clarity on the order in which one should account for the tax treatment of Debt Relief and further included the scope to account for any situation where Debt Relief was given. Under the 2012 Amendment Bill the tax implications and ordering consideration of Debt Relief is as follows, if the Debt Relief:

- Is as a result of a bequest to an heir or legatee for a property of an estate then estate duty is applicable;
- Qualifies as a donation then only donations tax is applicable;
- Is as a result of an employee/employer relationship the amount will be considered a taxable fringe benefit subject to PAYE;
- Is not subject to the above the ordinary income rules will apply (detailed below);
- Is not subject to any of the above then capital gains rules will apply (detailed below).

The 2012 Amendment Bill further sought to limit the tax implications of Debt relief for a company while still trying to ensure that this was not abused. The 2012 Amendment Bill therefore provided for Debt Relief to be dealt with in the following way:

- Ordinary income – as with the previous rules this is applicable whenever the original debt was used to finance deductible expenditure or allowance assets but does not constitute a bequest, donation or remuneration. In such event the Debt Relief will be dealt with as follows:
 - If the debt was utilised for trading stock and such trading stock is still held by the debtor and still has a cost price, then the cost price of the trading stock will be reduced to the value of the Debt Relief granted; and/or
 - Ordinary revenue will be recognised to the extent of the Debt Relief granted. Note that this is only applicable for allowance assets to the extent that there is any residual left over after the base cost has been reduced to zero and for trading stock to the extent that there is any residual left over after applying the trading stock rule above.
- Capital Gains/Relief – this will be applicable if the initial debt was not used to finance deductible expenditure or allowances and is not a donation, bequest or fringe benefit. In such event the Debt Relief will be dealt with as follows:
 - If the debtor still holds the asset that was funded by the debt, then the base cost of that asset will be reduced to the extent that any remaining base cost still exists; and/or

- If the debt cannot be traced to a specific asset held by the debtor or the base cost of the asset has been reduced to zero, then the remaining debt relief will be set off against any assessed capital losses the debtor may have; thereafter
- There will be no further tax impact to the debtor (i.e. no capital gains will be applicable).

In the event that the Debt Relief is granted for assets that existed prior to 1 October 2001 (pre-effective date assets) the base cost of the asset will need to be determined before applying the Debt Relief rules above. As with any other asset the pre-effective date asset base cost is determined based on either of the: market value method, time-apportioned base cost method; or 20% of proceeds method. In order to apply and calculate the base cost using one of these methods a disposal is required, therefore a disposal equal to the market value of the asset immediately before the Debt Relief is applied is deemed to have taken place for the application of these methods.

Despite the above the previous rules applicable for group companies and liquidation relief will still apply as per paragraph 56(2) of the Eighth Schedule of the ITA. Further the above rules will not apply to Debt Relief for tax debts as tax debts do not fall within in the definition of debt in the ITA. In such cases the Debt Relief will be offset against other taxes that may be due to SARS by the debtor, if such offset is possible, otherwise there will be no further tax consequences.

The following changes were made to the ITA as part of the 2012 Amendment Bill to cater for the changes in the tax treatment of Debt Relief as detailed above:

- Change in the debt definition and corresponding wording throughout the ITA (where applicable);
- Inclusion of S8(4)(a)(ii);
- Deletion of S8(4)(m);
- Inclusion of S19;
- Deletion of the proviso to paragraph (a) of S20(1);
- Amendment of paragraph 3(b)(ii) of the Eighth Schedule;
- Deletion of paragraph 12(5) of the Eighth Schedule;
- Inclusion of paragraph 12A to the Eighth Schedule;
- Amendment of paragraph 20(3)(b) of the Eighth Schedule;
- Amendment of paragraph 40(2) of the Eighth Schedule; and

- Amendment of paragraph 56(2)(a) of the Eighth Schedule.

The most significant of these changes pertain to the inclusion of S19 which deals with the tax treatment Debt Relief concerning ordinary income and paragraph 12A to the Eighth Schedule which deals with the tax treatment of Debt Relief concerning capital gains.

The 2012 Amendment Bill introduced several changes into the ITA for the benefit of the debtor (the party receiving the compromise) in the event of Debt Relief granted. The most important implication of these changes is that it limits and/or defers the financial impact caused by the application of Debt Relief tax legislation. This is particularly true for Debt Relief granted for capital assets (which can potentially result in no tax consequence) and for allowance assets and trading stock still on hand (which may result in no tax consequence until a disposal takes place). It is further assumed that the majority of companies that would be seeking Debt Relief would also have large assessed losses which can be used to further defer the tax implications caused by Debt Relief.

It appears as though the application of the new Debt Relief will be most beneficial for companies that are very capital intensive and carry large amount of stock on hand that may not be easily sold. In cognizance of this the manufacturing industry and start-up companies in general may benefit highly from the new Debt Relief rules (both of which have been identified as areas that need government support and are critical for economic growth).

Over all it appears that, other than changes to the tax implications of Debt Relief, no other specific changes have been made to the tax legislation to cater for companies in BR (based on a review of the tax changes to the ITA and VAT Act).

3.1.2. General tax consequences based on 'average' BR plans

A company can only enter BR if it is financially distressed as defined in S128(1)(b) of the Companies Act. In order for the company to overcome its financial distress it would therefore need to restructure, as mandated by S128(1)(b)(iii) of the Companies Act, one or more of the following:

- Affairs;
- Business;
- Property;
- Debt and other liabilities; and
- Equity.

The tax consequences of these various restructures will depend on the specific way in which they are structured as well as what is done. What is evident, however, is that the restructuring needs to ensure that the company is in a better financial position. Therefore, an average BR plan would include one or more of the following:

- Various strategies to make the enterprise more profitable such as reducing operating costs or increasing revenue;
- Sale of the business assets including properties;
- Compromise with creditors;
- Conversion of debt to equity (*in practice this seems to only be applied where an option to do so existed before the company entered into BR*);
- Introduction of new debt;
- Introduction of new shareholders; and
- Introduction of other types of shareholders.

The tax consequences of the above will generally be dealt with as follows:

- Various strategies to make the enterprise more profitable such as reducing operating costs or increasing revenue;
 - These will be dealt with in terms of the normal provisions of the ITA, namely:
 - Gross income less allowable deductions and exceptions;
- Sale of the business assets including properties;
 - This will be dealt with in accordance with the 8th Schedule of the ITA;
- Compromise with creditors;
 - This will be dealt with, as detailed above, in accordance with S19 of the ITA and the 8th Schedule of the ITA (particularly para 12A);
- Conversion of debt to equity (*in practice this seems to only be applied where an option to do so existed before the company entered into BR*);
 - Any conversion of debt to equity will be dealt with in terms of the 8th Schedule of the ITA (para 11);
 - The specific tax consequences arising from this type of transaction will depend on how the transaction is structured and what the nature of the assets being exchanged are;
 - If the conversion is done for any amount less than or more than market value, additional tax consequences may arise as per Para 12A of the 8th Schedule of the ITA;
 - S8E or S8EA may be applicable to the transaction depending on the type of equity conversion (i.e. any equity other than ordinary equity shares);

- Introduction of new debt;
 - There would be no immediate tax consequence for this, however, depending on the structure of the transaction the debt may fall under the classifications of S8F, Hybrid Debt Instruments. In such a scenario the interest payable on the debt would not be tax deductible.
- Introduction of new ordinary shareholders;
 - There will be no immediate tax consequence for this, however, future disposals will be dealt with in accordance with the 8th Schedule of the ITA;
 - Any income (dividends) received from these shares will be dealt with in terms of gross income less the any applicable exceptions detailed in S10(k);
 - Additional dividend consequences may occur from the application of Part VIII of the ITA (S64D to 64N);
 - Depending on the specifics of the transaction the introduction of new shareholders could be done in terms of the corporate rules (Part III of the ITA). In such scenario S41 to S47 of the ITA will also apply. It should be noted that there are several anti-avoidance provisions included in the ITA that continue to be promulgated into the ITA each year to limit the use of these provisions. This has resulted in provisions that are fairly complex and do not seem to be used by BRP's in their BR plans;
- Introduction of other types of shareholders;
 - One of the ways for the company to introduce additional capital is through issuing of preference and other types of shares. This may be beneficial for new investors as they are afforded preferential or more favourable rights over old shareholders. In some cases they may also obtain ordinary shareholder voting rights in the event there are any dividends outstanding. They are thus able to influence the outcome of the company to protect their investment;
 - The ITA, however, currently contains several anti-avoidance provisions to reduce the appeal of these types of shares/instruments for both the holder and issuer; namely S8, S8EA, 8FA, S23k, S23N of the ITA. The main consequence of these provisions is to ensure that the dividend income received from these shares is treated as income accrued in the hands of the security holder during the year of assessment.

3.1.3. Current problems faced in the application of the Tax Laws

While BR is relatively new to SA law there are currently dozens of legal cases pertaining to BR, however, the vast majority of the cases relate to court applications to either put a company into BR as per Section 131 of the Companies Act or to prevent a company from entering into BR as per Section 130 of the Companies Act.

To date there are only a handful of legal cases concerning SARS and companies in BR, however, none of these cases relate to disagreements with the application of the tax legislation by the BR company but are predominately focused on issues around the application of the Companies Act by BRP's. Based on a review of these cases it appears that SARS's biggest concern/contention with regard to companies in BR is based on whether or not their claims should be treated as preferential claims or not.

SARS is currently of the view that any tax liabilities that arise from the submission of tax returns, regardless of the period to which they relate, should be treated as post-commencement finance. If this view is upheld it would mean that, in terms of S135 of the Companies Act, SARS would be a preferential creditor over all unsecured creditors. SARS has also sought to use S135 of the Companies Act to disregard other unsecured creditors right to vote on the BR plan.

To date there has been only one case which deals with the status of SARS as a creditor in BR, *Beginsel MB and others (The Commissioner for South African Revenue Services vs Beginsel MB and Others, 2012)*. The key facts of the case were as follows:

- The Company, Makhuba Logistics (Proprietary) Limited, experienced financial difficulty and on the 26th July 2011 the company was placed under provisional liquidation as a result of legal proceedings initiated by the company's creditors;
- On 14th October 2011, after an application brought forth by the company's shareholders, the provisional liquidation was converted into BR proceedings;
- The initial intention of the BR was not to liquidate but rather restore the company to solvency and to continue as a going concern;
- SARS had a claim against the Company of R11.2m for various outstanding indirect taxes that had arisen prior to BR. The BRP was originally of the view that SARS was a preferential creditor under BR;
- During the BR proceedings the Company's financial performance started to improve with the company ultimately becoming profitable;
- During 2012, due to unforeseen circumstances and changes in the market place, the company began to experience large decreases in turnover and profitability. The BRP advised the creditors that under the current trading conditions it would not be possible to 'turn the company around' in the short to medium-term. The BRP therefore decided that it would be better to wind up the company to avoid further losses;

- Through winding up the company the BRP anticipated that R23.4m would be available for secured and preferential creditors and R34.3m would be available for concurrent creditors through two dividend payments of 2c/R and 13c/R;
- At this point the BRP had obtained legal advice and was of the view that SARS was not a preferential creditor but merely a concurrent creditor. SARS disagreed with this view and tried to have the BR plan altered to reflect them as preferential creditors which the BRP ultimately declined to do; and
- On 17th July 2012 at the creditors meeting sixteen creditors with an aggregate claim of R102.4m were present, all of the creditors were unsecured creditors. Based on the voting rights 87% of the creditors voted in favour of the plan, 12% (being SARS) voted against the BR plan, and 1% abstained from voting.

Following this on 2nd August 2012 SARS applied to the courts for the following substantive relief, that:

1. The creditors meeting to approve the BR plan be declared unlawful and invalid;
2. An interdict be placed on the BRP's preventing them distributing any money;
3. The BRP's discontinue BR and place the company in liquidation; and
4. Interim relief be granted to SARS.

A core issue of the case was whether SARS had a statutory or other preferential claim in terms of Chapter 6 of the Companies Act. While SARS acknowledged that Chapter 6 of the Companies Act does not oblige the BRP to treat SARS as preferential over unsecured creditors it nonetheless does not oblige the BRP to treat SARS as a concurrent creditor. SARS contended that as per S135 of the Companies Act their claims should be classified as post-commencement finance, and further to this as per S99 and S103 of the Insolvency Act, read with S145(4) of the Companies Act, their claims should rank ahead of concurrent creditors who would otherwise be subordinated in a liquidation scenario and therefore have no voting rights in BR.

In this regard the court found that SARS's construction of S145(4) of the Companies Act was contrary to the ordinary grammatical meaning of the words used in the section and also lead to an illogical result in that it did not balance the rights and interests of all the relevant stakeholders as required by S7(K) of the Companies Act. The courts found that the wording of S145(4) was clear and unambiguous.

The courts further found that if Chapter 6 of the Companies Act had intended to grant a SARS statutory preferential right such as those contained in the Insolvency Act then the Companies Act would have done so. The court thus concluded that SARS is not a preferential creditor in BR by virtue of its preferential status in the Insolvency Act.

Another issue of interest dealt with in this case was whether, after deciding to wind up the company, the BRP's were obliged to place the company in liquidation in terms of S141(2)(a) of the Companies Act. The courts concluded that in the event that the company was placed into liquidation, rather than being liquidated while in BR, this would result in a reduced return to the creditors given the duplicate work the liquidator would have to do and ultimately only benefit SARS who would become a preferential creditor.

While this case provided some answers as to whether or not SARS is by default a preferential creditor in BR it did not provide further insight as to whether:

- The time that tax return is submitted (i.e. pre or post commencement of BR) has any impact on the preferential ranking of SARS claim; and
- The submission of direct and indirect tax returns should be treated in the same way.

4. Chapter 4: Evaluating the financial impact of the Tax Laws

Based on the statistics available and an analysis of existing BR cases it is evident that:

- BR has been largely unsuccessful in terms of rehabilitating companies;
- BRP's typically do not seem to consider or take into account the tax implications that arise from the BR plan; and
- BR plans tend to focus on the short-term and, despite being required to take into account a three-year forecast, do not seem to put measures in place to ensure the long-term prospects of the BR Company.

In light of the above problems this chapter is focused on analysing the existing Tax Laws to identify which, if any, may result in less adverse financial impacts and/or provide for better long-term prospects for the company for a company in BR.

4.1. Measurement criteria use to evaluate financial impact

In order to evaluate the financial impact of particular tax law on a company we first need to determine an appropriate measurement criterion that can be used to assess the extent of the financial impact.

There are many types of financial measures or ratios that business analysts, accountants, investors, etc. use when evaluating businesses, however, the usefulness and appropriateness of the measurement criteria no doubt depends on what one is looking to 'maximise'. When looking at BR one would need to find a criteria or set of criteria that fulfils the requirements and aims of, as far as possible, the Companies Act, namely:

- As per S7(k) balances the rights and interests of all stakeholders; and
- Assess the overall impact and feasibility of a particular BR plan on the business (forward looking).

A meaningful measurement criterion would therefore need to be something that:

- Considers the interests of multiple stakeholders (no consideration is given to their rights as practically their rights are protected by adherence of the BRP to the Companies Act); and
- Considers not only historical performance but also the future potential of the business.

While there are several means of measurement criterion that one may look at to determine the value or success of a business such as profitability, price earnings, return on investment, headline earnings per share, cash headline earnings per share etc. These are not an effective means of measurement for determining the feasibility or overall impact of a BR plan as they are historical in nature and do not necessarily consider more than one stakeholder.

It is clear from the above that a meaningful measurement criterion for evaluating the financial impact of a company in BR is a fairly complex task. This problem can be solved by first assessing what we are trying to 'maximise' in the company. Taking into account Section 2.1.3 and 2.2 above what appears to be a central reason for companies becoming financially distressed, as defined in the Companies Act, is limited cash flow. Without cash flow companies are unable to settle their debts as they become due and unable to secure the resources that are required to continue operating.

The term cash flow is somewhat vague and can differ in meaning depending on individual perspectives (company, creditor, or stakeholder etc.). In a company there can be various types of cash flow, namely:

- Net cash flow from operating activities (includes cash paid to employees and suppliers);
- Net cash flow from the working capital cycle (this includes cash payable to suppliers);
- Net cash flow from investing activities (includes the acquisition and sale of assets);
- Net cash flow from financing activities (includes the acquisition and settlement of loans and equity);
- Cash payable to creditors and employees; and
- Cash payable to/by shareholders (this includes dividends and equity acquisitions).

One also needs to consider that, as per financial management principals, that there is a 'time value' to money; the future value of money is not the same as the present value (i.e. R100 today will not be able to buy you the same quantity of goods and services in the future). In almost all cases the value of money decreases over time therefore R100 today is worth more than R100 in the future.

In addition to the above considerations one also needs to take into account the risk associated with any particular choice. As the future is inherently uncertain the longer time frame one needs to wait to receive their money the more risk one has of not receiving payment.

Using the above considerations, we can thus summarise our requirements for a measurement criterion as follows, we need something that:

- Takes into account historical performance and future potential;
- Relates to the actual cash flows of the business and not just 'on paper' values;
- As far as possible considers all cash flows associated with the business (as the business is the central consideration the cash flows of the business impact all stakeholders);

- Must take into account the time value of money; and
- Must take into account the overall business risk.

While there is no single accounting ratio or statement that may provide us with all of these criteria there is a widely used valuation approach that can be used that addresses these criteria, namely the Discounted Cash Flow (“DCF”).

4.2. Understanding the Discounted Cash Flow Approach

The DCF is a valuation methodology used to determine the ‘market value’ of a business. The generally accepted definition of ‘market value’ is the value as applied between a hypothetical willing vendor and a hypothetical willing prudent buyer in an open market and with access to all relevant information. The objective of the DCF would thus be to estimate the exchange price at which hypothetical market participants would agree to transact (Fiber, 2004).

The DCF methodology assumes that the value of any asset, including a business, can be determined according to the present value of the net cash flows that the asset is likely to generate in the future.

The central aspect of the DCF is that it is forward looking in nature, thus in order to perform a DCF one needs to start with a minimum of a 3 to 5 year forecast for the company (a minimum of a 3-year forecast is already a requirement of the Companies Act). This DCF forecast needs to include cash flows relating to the following:

- Operating activities of the business;
 - This is determined by taking the income statement and adjusting for non-cash items such as depreciation and excluding finance costs and taxation. These net cash flows are referred to as the Earnings Before Interest, Tax, Depreciation and Amortisation (“EBITDA”).
- Working capital cycle;
 - Working capital is made up of the net value of investment into inventory, the value of debtors financed and the value of creditors financing. In order to determine the working capital cash flows we need to look at the period to period movement in this value. In other words, this is the change in the net value of Inventory + Debtors – Creditors.
- Capital expenditure (“CAPEX”);
 - This would include all capital expenditure required by the business over the forecast period including any expansion and replacement capital.
- Taxation (“Tax”);
 - This would include all income tax and capital gains taxes less any assessed losses or capital losses. The cash flow impact of Vat and other such indirect taxes would be included in the working capital cycle.

The net value of these four cash flows is what is referred to as the Free Cash Flow ("FCF").

In addition to the FCF a further value is also determined which is called the perpetuity value; this is the combined estimated value of all the additional FCFs that the business is expected to generate over its lifetime, assuming no further real growth, after the last forecast period.

It should be noted that in order to determine a reasonable forecast one would use the historical company performance as a starting point (typically 3 years of historical information). One would then forecast the proceeding years based on the company strategy (BR plan), the possible impact of new laws and regulations, and by taking into account as far as possible various macro and micro economic factors such as the inflation rate and industry norms.

The FCF and perpetuity value of the business is then converted into its present values by discounting these cash flows by a weighted average cost of capital ("WACC"), this value is known as the value of operations.

The WACC is an integral part of the DCF. The WACC is very specific to each business and accounts for the specific situation and circumstances of each business. The WACC is made up of an estimated cost of equity and after tax cost of debt, blended in proportion to the level of gearing (level of debt in relation to equity) which the operation is expected to assume.

The cost of equity is normally calculated using the Capital asset pricing model ("CAPM"). The CAPM is determined by taking account of the relative risk of the company, and therefore the theoretical return that will be required by the equity holders of the company. The CAPM model therefore incorporates various risks attributable to the business and the potential risk that would be attributed to the equity holders of the company including the potential risk of them not getting their investment back.

The after tax cost of debt is calculated by taking the current cost of debt to the company (or anticipated cost of new debt if this is more appropriate) and reducing this by the prevailing income tax rate. The cost of debt generally takes into account long-term debt costs rather than short-term debt. If the company anticipates utilising large levels of short-term debt, such as overdraft facilities, on an ongoing basis the debt rate should be adjusted to take short-term debt costs into account. The cost of debt takes is primarily based on the level of risk associated with lending the company money. The cost of debt therefore takes into account the level of risk to financiers.

The final step of the DCF is to take the value of operations, as determined from the present value of the FCF and perpetuity value, and adjusting this by the market value of the company's non-core assets (including loans due to the company), excess cash and

cash equivalents, and long-term debts. This final value is the equity value (“EV”) of the company. The EV is the theoretical value of the company if the company were to continue to trade. If we anticipate selling the company, then this value would be further reduced by minority and marketability discounts where applicable. For the purpose of our evaluation we assume that the business will continue to operate and therefore will be using the equity value as our measurement criteria.

4.3. Appropriateness of the DCF and how it may be used

Taking into account our initial requirements for a measurement criterion stipulated in 4.1 above it is clear that the DCF approach satisfies all of these requirements. This is detailed below.

- Takes into account historical performance and future potential – Yes through the use of forecasting combined and using historical figures as a base. The BR plan would be an integral aspect of the forecast as it should relate to the forecast of the BR plan;
- Relates to the actual cash flows of the business and not just ‘on paper’ values – Yes through the determination of the FCF;
- As far as possible considers all cash flows associated with the business – Yes by considering multiple cash flows in the determination of the FCF;
- Must take into account the time value of money – Yes through the conversion of the FCF to a present value using an appropriate WACC; and
- Must take into account the overall business risk – Yes through the calculation of an appropriate WACC which incorporates the CAPM.

Additional benefits of the DCF include:

- It forcing one to take into account the cash flows attributable to tax when calculating FCF (in this way it becomes more difficult for the BR practitioner to not consider the tax implications of the BR plan, however, they may still not adequately take the tax into consideration);
- Highlights the impact of changes in the gearing on the company (this is particularly relevant if a business strategy requires the recapitalisation of the business or some form of debt to equity conversion); and
- It can assist in determining whether a company is able to be rehabilitated. If the overall EV is negative this implies that the business is better off being liquidated as the company will most likely never be able to generate sufficient positive cash flows. This is especially true if the value of operations is negative.

The net result of the DCF is the determination of the company’s EV. The EV is the means by which we can assess the financial impact of the BR plan and more specifically the financial impact of the Tax Laws.

The use of the EV is relatively straight forward, namely:

- An increase in the EV implies that the overall financial impact is positive; and
- A decrease in the EV implies that the overall financial impact is adverse.

What one must not lose sight of is that the DCF is a tool and the usefulness of any tool is based on how it is used. The reasonableness and accuracy of the DCF is based on the accuracy and the reasonableness of the assumptions and information used to populate it. Further the DCF may also require some interpretation and 'balancing'; one may be able to maximise the EV of the company but this may come at the expense of some of the other stakeholders in the company. Therefore the BR practitioner will need to consider both the hard (final EV) and soft issues (the impact on various stakeholders).

4.4. Financial impact of various potential tax strategies

There are many tax strategies that one may apply to a company both within and outside of BR. For the purpose of this dissertation these tax strategies have been limited to the following areas:

- Debt Relief as it pertains to revenue, capital and tax debt (SS8, S19, S20, and the 8th Schedule of the ITA);
- Corporate restructuring transactions (S41 to S47 of the ITA); and
- Debt and Equity transactions (S8E, S8EA, S8F, S24BA, S40C S40CA of the ITA).

The assessment of the financial impact of these laws has been considered primarily from an EV perspective but also by taking into account non-financial issues. The assessment is therefore primarily a quantitative analysis with some aspects of qualitative analysis.

4.4.1. Debt Relief

The tax impact on the EV of a particular compromise is dependent on the nature/source of the Debt Relief, however, the impact of the actual Debt Relief is fairly consistent. The actual Debt Relief has the effect of either leading to a reduction in the company's working capital (reduction in trade creditors including SARS taxes) or borrowings (loans, overdrafts, etc.). Any reduction in these debts reduces the company's cash flow obligations and therefore results in an increase in the EV of the company. Such increases in the EV are therefore positive to the company. The positive impact on the EV does not take into account the impact that such Debt Relief may have on the company's credit or trade terms (unless these factors are calculated into the DCF). If the company loses its credit facilities this could have an adverse effect on the EV and may contribute to an overall decrease in EV.

In order to assess the financial tax impact of Debt Relief one needs to understand the full extent of what is happening when Debt Relief is granted. When Debt Relief is granted the debt (the obligation to pay out cash) ceases to exist, however, an immediate taxable income is created (practically one could consider this process as a

conversion of debt to taxable income). Through the various Debt Relief tax rules this immediate taxable income is reduced and in some cases eliminated altogether. This reduction or elimination of taxable income, depending on the specific situation, comes at the cost of a loss of current or future tax deductions. From a tax perspective the Debt Relief therefore grants some immediate cash flow relief but in most cases does not remove the tax obligation (i.e. future tax cash flow obligations continue to exist and may even be increased).

From an overall cash flow perspective a theoretical conversion of a debt to taxable income is preferable as only a portion of the taxable income is payable, 28% being the company's tax rate, compared to the full portion that would be payable to suppliers. What becomes apparent, however, is that regardless of how preferable this situation may be it is still not ideal for the company. The reason for this is because each Rand of Debt Relief received by the company is diminished by an obligation to pay SARS or through the loss of future and current tax deductions (i.e. increased current and/or future tax obligations). From this perspective alone it is clear that any taxation of Debt Relief is counter intuitive and only makes it more difficult for the company to get itself out of cash flow problems. One could take this a step further and argue that SARS is capitalising on the losses sustained by creditors by benefiting from the cash that the creditor is in effect forced to forgo. The extent to which SARS benefits would be situation dependent and also be based on whether SARS allows the creditor to claim the Debt Relief granted as a tax deduction.

With regard to the tax implications on the company EV the following is applicable:

- For the reasons detailed above Debt Relief will always create some form of additional tax obligation to the company. In time, assuming no further Debt Relief granted by SARS, this obligation will result in a cash outflow. For this reason all Debt Relief received by the company will always result in a reduction in the EV. This is true for all the Debt Relief rules applied except for some specific scenarios relating to debt relief originating from debts owed to SARS and capital assets that were not subject to allowances. In such cases the overall impact on the EV may be limited to zero.

The one benefit that financially distressed companies have is that they would generally have large assessed losses or may have started creating assessed losses. These assessed losses would assist in reducing the immediate cash flow implications for the company at the expense of future cash flow savings. Overall any loss of an assessed loss would still, however, result in a decrease in the EV.

Practically if the company does not have an assessed loss and does not have any cash or available cash this additional tax implication could lead to further

financial distress for the company in the short-term. This would in turn either lead to the need for further Debt Relief which would may become a circular problem (more Debt Relief creates more tax obligations). Alternatively the company may end up having to apply to SARS for Debt Relief. In such scenario it would most likely be better for all stakeholders if SARS agrees to forgo the tax implications of the Debt Relief from the outset.

- The ordinary income rules (see 3.1.1 above) seek to limit the negative financial impact of the Debt Relief by reducing the cost price of trading stock or base cost of an allowance asset by the extent of the Debt Relief granted. If after reducing the cost price or base cost of the asset to zero there is still a residual Debt Relief this value is recognised as a taxable income in that year of assessment.

These rules therefore seek to reduce or eliminate the immediate tax implication of the Debt Relief by reducing or eliminating the current and future tax deduction of the company.

From an EV perspective, due to the time value of money, any deferral of a cash outflow will result in a higher EV. The increase in the EV will be dependent on the time period of the deferral. For trading stock there may be no significant deferral as it is assumed that the company will need to sell its trading stock as soon as possible to provide cash flow for the business. If the company sells the stock in the same tax year there would be no deferral and thus a zero increase in the EV. Another possibility for the company is that if they have already written the stock off as slow moving or obsolete stock, in this situation an immediate taxable income would be created which would also decrease the EV. For an allowance asset the impact on the EV would be partly dependent on when the asset is sold. One would assume that the company would keep the asset for more than one tax year which would result in an increase in the EV. The other financial impact of an allowance asset is that the company would have a reduced or zero base cost. In such case the company would lose its annual tax deductions which would happen from the first tax period onward. This would result in a decrease in the EV of the company.

Overall Debt Relief that is subject to the ordinary income rules will always result in a decrease in the EV of the company.

- The capital gains/relief rules (see 3.1.1 above) seek to limit the negative financial impact of the Debt Relief by reducing the base cost of an asset to

the extent of the Debt Relief granted when the asset is still on hand or identifiable. If the debtor cannot identify the specific asset that the debt funded or after reducing the base cost to zero there is still a residual amount this will be set off against any assessed capital losses that may exist. Thereafter there is no further tax implication for the Debt Relief.

As with the ordinary income rules, from an EV perspective, due to the time value of money, any deferral of a cash outflow will result in a higher EV. The increase in the EV will be dependent on the time period of the deferral. With assets of this nature it is generally assumed that they will be held for longer time periods and by definition there are no allowance deductions applicable. For this reason the application of these rules will result in an increase in the EV. The benefit that the capital gains/relief rules have over the ordinary income rules is that they impact the assessed capital losses, if there are any, and thereafter have no impact. As a result of this in the worst case the decrease in the EV will be limited to the extent of the assessed capital losses. In best case the impact on the EV will be zero.

An additional consideration with regard to capital assets is that the by the time the asset is sold in the future one may still be able to apply a base cost to the asset which may limit or nullify the reduced base cost. This is particularly true if one is able to apply the 20% of proceeds rule.

- While tax debts do not fall within the definition of debt in the ITA they are still practically a form of Debt Relief. In such cases the Debt Relief will be offset against other taxes that may be due to SARS by the debtor, if such offset is possible, otherwise there will be no further tax consequences.

The implication of this Debt Relief will result in either no change in cash outflows (i.e. the taxpayer no longer owes SARS money but SARS no longer owes the tax payer money) or it may result in a reduction in cash outflows in the situation where SARS does not owe the tax payer any money. Where a set off applies there will be no change to the EV, however, where there is no set off applicable there will be an increase in the EV.

4.4.2. Corporate restructuring

The corporate restructuring rules are dealt with in Part 3 of the ITA and deal with ways in which companies may restructure themselves and their assets. The corporate restructuring rules can be fairly complex and have many claw back provisions that may create adverse tax implications for the company. Further the corporate restructuring rules have been subject to much change and modification over

the years by SARS. Many of these changes have been in response to tax payer abuse of these rules. For these reasons corporate restructuring can be considered a specialty field within the ITA requiring specialty knowledge and skill.

As the corporate restructuring rules detail many scenarios and types of transactions. A full analysis of the corporate restructuring rules is that beyond the scope of this dissertation. For this reason the financial impact of these rules has been limited to a high level overview. Of particular interest to us are transactions that may be applicable to BR strategies, more particularly with reference to transactions with creditors or existing shareholders. An overview of the corporate restructuring rules, in this context, is detailed below.

- S42 of the ITA – Asset-for-share transactions.
 - Description: This is when a capital asset or trading stock is exchanged for equity shares. The equity shares do not need to be granted to an existing shareholder, however, the acquiring shareholder must acquire at least 10% of the equity shares and voting rights in the company or the equity shares must be held by a person that forms part of the same group of companies.

These types of transactions can be used to convert large creditors of the company into shareholders thereby reducing the company debt and creating a vested interest for creditors in the company.

- S43 of the ITA – Substantive share-for-share transactions.
 - Description: This refers to a transaction whereby a person disposes of an equity share in the form of a linked unit in that company and acquires an equity share other than a linked unit in that company.

These types of transactions can be used to restructure the company's equity into different forms of equity.

- S44 of the ITA – Amalgamation transactions.
 - Description: This refers to a transaction where any company, which is resident, disposes of all of its assets (other than those required to settle debts which have been incurred in the ordinary course of trade) to another company by means of an amalgamation, conversion or merger. After the amalgamation the company that disposed of its assets will be terminated.

These types of transactions can be used to restructure the company whereby less profitable companies are amalgamated with more

profitable companies in order to give them a better chance of recapitalising themselves.

These types of transactions may also be used to amalgamate a BR company and major creditor. In this way the BR company may be able to merge with a key creditor thereby providing advantages for both companies.

- S45 of the ITA – Intra-group transactions.
 - Description: This refers to a transaction where any asset is disposed of by one company to another company that is resident and both companies form part of the same group of companies as at the end of the day of the transaction.

These types of transactions can be used to restructure the companies within a group whereby assets of less profitable companies are disposed of to more profitable companies in order to give the profitable companies a better chance of recapitalising themselves and becoming more efficient.

- S46 of the ITA – Unbundling transactions.
 - Description: Refers to a transaction where equity shares in a resident company which are held by another resident company (unbundling company) are distributed to any shareholder of the unbundling company in accordance with the effective interest of the shareholders in the unbundling company.

These types of transactions may be used in the event that the BR company has decided to unbundle some or all of the companies in a group.

- S47 of the ITA – Transactions relating to liquidation, winding-up and deregistration.
 - Description: This refers to a transaction where any company which is resident disposes of all of its assets (other than assets it elects to use to settle any debts incurred in the ordinary course of its trade) to its shareholders in anticipation of or in course of the liquidation, winding up or deregistration of that company.

These types of transactions may be used in the event that the BR company has decided to liquidate some or all of the assets in a group.

Overall the corporate restructuring rules seek to provide tax relief to companies, existing equity shareholders and new equity shareholders provided that the transactions are concluded in accordance with these regulations. The tax relief granted depends on the nature of the transaction but may include a deferral or capital gains tax as well as the elimination of other taxes such as Vat, Securities Transfer Tax ("STT"), Transfer Duties, etc.

A benefit of the corporate restructuring rules for a company in BR is that may allow the company to restructure its business into a more economical and effective structure with little to no tax consequences. Further it provides a mechanism whereby the company may be able to attract new assets or amalgamate with another more stable company with little to no tax consequences. Additionally through an effective restructuring the company may be able to convert some of its creditors into shareholders thereby reducing its overall debt. By finding a way to convert the company's creditors into shareholders the company may have a better chance at success (by definition a shareholder would be more invested in the long-term outlook of the company than a creditor).

A final potential advantage of the corporate restructuring rules is some of the claw back provisions, such as S42 Asset-for-share transactions, are triggered by a time criterion. These claw back provisions may then have the added benefit of forcing the transacting parties to remain together for a longer period of time (more than 18 months). While this time period cannot be considered long-term in nature the nature of the transactions tends to be more long-term in nature.

It is not possible to determine the full impact on the company EV of a restructure as it is dependent on the specific transaction. As a general principal companies tend to not restructure themselves if there will not be an overall financial benefit such benefits, would generally, result in an increase in the company EV. Further for a company in financial distress any deferral of elimination of tax will have a positive financial impact and result in an increase in the company EV. It should be noted, however, that if not for the restructure there would be no potential for additional taxes therefore the overall tax impact of a restructure would be result in a negative or zero change in the EV.

In the case where a company is able to restructure so that it is able to convert its creditors to shareholders this will have a mixed impact on the EV. The initial reduction in creditors would lead to an increased EV, however, the lower effective gearing would increase the WACC. This increase in WACC would reduce the EV. Whether the overall impact is positive or negative would be based on the specific transaction and the extent of each of the changes.

4.4.3. Debt and equity transactions

Debt and equity are the two fundamental ways in which a company may recapitalise itself. From a tax perspective these transactions are generally straight forward. For the issuing of new equity shares there is no immediate tax consequence, however, tax consequences will arise from any transactions with or by the existing equity shareholders. New debt raised by the company will also not attract any immediate tax consequences, however, the company may be able to claim tax deductions for any interest paid on the loan.

These types of transactions are not the only potential debt and equity transactions that exist in the ITA. Aside from the types of transactions detailed in Part 3 of the ITA covered in Section 4.4.2 above other transactions include acquisition of assets in exchange for shares or debt, debt for equity conversions and hybrid debt/equity instruments.

The acquisition of assets in exchange for shares or debt issued is dealt with in S40CA of the ITA. As per this section if a company acquires any asset, as defined in Paragraph 1 of the 8th schedule, from any person in exchange for issued shares then the company is deemed to have incurred an amount of expenditure in acquisition of the shares equal to the market value of the shares immediately after the acquisition. If the company issued debt then the company is deemed to have incurred an amount of expenditure in respect of the acquisition of the asset equal to that amount of debt. Neither of these transactions result in any immediate tax implication, however, they may give way to taxable deductions in the form of allowance asset deductions. It should be noted that in the event that a similar transaction is done in terms of Part 3 of the ITA then S40CA would not be applicable.

S24BA of the ITA deals with transactions where assets are acquired as consideration for shares issued and the transaction is not done at an arm's length. In terms of this provision if the asset received is of a higher market value than the shares issued the company is deemed to have a capital gain to the extent of the difference in the asset value and share value. The tax impact of such a provision would have the effect of reducing the EV.

S8E deals with hybrid equity instruments. In terms of S8E the dividends on these instruments are deemed to be income in the hands of the recipient. S8E effectively deems any share that is not an equity share and is reasonably expected to be redeemed or settled within 3 years to be classified as a hybrid equity instrument. This includes any preference shares that are not held for a qualifying purpose as defined in S8EA of the ITA.

S8EA deals with third-party backed shares. In terms of S8EA the dividends on these third-party backed shares are deemed to be income in the hands of the recipient. A

third-party backed share is defined as any preference share in which an enforcement right is exercisable by the holder of that preference share or an enforcement obligation is enforceable as a result of any amount of any specified dividend or return not being received by or accrued to the holder of the preference share.

S8 and S8EA both result in similar outcomes. From a company perspective there will be no tax implication for these types of transactions, however, the legislation seeks to place a penalty on the holder of the instruments/shares in the form of an income/expense mismatch. The mismatch is created by the company not being able to deduct the dividend payment while the holder is required to pay tax on the payment received. This penalty would no doubt end up reducing the use of these types of instruments/shares which may have a negative impact on the company.

S8F deals with hybrid debt instruments. S8F seeks to limit the deduction of interest payments relating to hybrid debt instruments. A hybrid debt instrument is defined effectively as any debt that will be settled, within 3 years, by the issue of shares. This provision places a penalty on the company by not allowing the interest on hybrid debt instruments to be deducted. This again creates an income/expense mismatch between the company and the instrument holder in that the company cannot deduct the expense but the holder may be required to pay tax on the amount. As such this penalty would no doubt end up reducing the use of these types of instruments which may have a negative impact on the company. From a financial perspective the non-deductibility of interest expenses would mean an increased taxable income and corresponding cash outflow. This would therefore cause a reduction in the EV.

Overall it appears as though SARS has sought to deter companies from making short-term use of any type of instrument that may be classified as a hybrid instrument or preference share. If, however, the company structures these transactions correctly (i.e. for longer than 3 year periods) the provisions of S8E, S8EA and S8F are largely not applicable.

The use of these types of instruments may be very useful for a company in BR to overcome its financial distress in that it may reduce the company debt without triggering the debt relief rules and force creditors to take a medium to long-term view of the company (i.e. more than 3 years). An example of this could be where the company converts creditors' outstanding debts to a share other than an equity share redeemable after a 3-year period. Such share may also attract a minimum annual dividend payment or redeemable at a premium which is used to compensate the creditors for the time value of money. In this way creditors do not lose any money and the company is given a temporary relief from its cash flow obligations. Further from the creditors perspective the payments that they receive would most likely end up being treated as dividends and therefore tax free.

As with the corporate restructuring rules if the company were able to convert its creditors to shareholders this will have a mixed impact on the EV. The initial reduction in creditors would lead to an increased EV, however, the lower effective gearing would increase the WACC. This increase in WACC would reduce the EV. The additional difference applicable with these instruments is that they will need to be redeemed at some point and may attract additional cash flow obligations. These implications of additional cash flow obligations would result in a decrease in the EV, however, depending on the length of time to redemption and the extent of the additional obligations there may still be an increase in the EV. Whether the overall impact is positive or negative would be based on the specific transaction.

5. Chapter 5

Chapter 3 of this dissertation identified what Tax Laws have been introduced to cater for BR and Chapter 4 assessed the financial tax impact of various possible BR strategies on the company. What has not so far been considered is whether the expenditure incurred by a company that pertain specifically to BR are tax deductible or non-deductible. Chapter 5 therefore deals with this issue.

5.1. Deductibility of BR costs

The reason why the question of the deductibility of BR costs is relevant is due to the fact that BR companies exist in a 'grey area'. BR companies are not the same, at least initially, as a company that is going through liquidation but at the same time they are not operating as a business is intended to due to being financially distressed. It is therefore clear that some ambiguity may exist in the tax treatment of BR specific costs.

As discussed in Chapter 3 there is currently very little tax case law pertaining to companies in BR and so far no specific tax cases concerning the deductibility of BR expenditure. Further, based on a review of the BR plans, not much consideration appears to have been applied to the deductibility of BR expenditure by the BR practitioners. For this reason the analysis on the possible deductibility of BR expenditure has been based on previous tax cases from non-BR companies.

In order to determine if an expense is deductible in terms of the ITA one would need to apply the general deduction formula. In terms of this an expense can only be deducted if it satisfies the criteria of S11(a) of the ITA while at the same time not excluded as per S23(g) of the ITA. Alternatively, if an expenditure is not deductible under the general deduction formula it may still be deductible under specific provision of the ITA. While each individual expenditure that the company incurs would need to be subject to this test for the purpose of this analysis and practical reasons BR expenditure will be considered as a single 'indivisible cost'. From this overall understanding one would then need to assess whether any specific costs fall within or outside of this framework based on the specific scenario.

In terms of S11(a) expenditure is deductible if it meets the following criteria:

- Actually incurred;
- During the year of assessment;
- In the production of income; and
- Not of a capital nature.

In terms of S23(g) and expense can only be claimed as a deduction to the extent that such expense was incurred for the purposes of trade.

These criteria have been discussed below.

5.1.1. Actually incurred

The case of PE Electric Tramway Co (Port Elizabeth Electric Tramway Company Ltd vs Commissioner For Inland Revenue, 1936) established the following principals in dealing with the concept of ‘actually incurred’:

- For an expense to be actually incurred it does not have to have been paid;
- An expense is actually incurred if there is an absolute and unconditional liability to pay the expenditure; and
- Actually incurred does not imply necessarily incurred (extravagant or unnecessary expenditure can still meet the definition of actually incurred).

BR expenditure is generally immediate in nature and are not payable based on some contingent future event such as the business being successfully rehabilitated. In light of this it is unlikely that there can be any contention that BR costs are not actually incurred. This aspect of the general deduction formula would therefore be satisfied. In addition to this, due to expenditure not having to be ‘necessarily incurred’, it is not for SARS to disregard any expenditure because on the basis that they may consider it unnecessary or extravagant.

5.1.2. During the year of assessment

For an expense to be deductible it must have been incurred and must be deducted in the year that it is actually incurred (Concentra (Pty) Ltd vs Commissioner For Inland Revenue, 1942). Given the general nature of BR expenditure being immediate in nature as long as they are quantified and brought into account before the end of the tax year they would be considered to have occurred during the year of assessment (Caltex Oil SA Ltd vs South African Inland Revenue, 1975).

5.1.3. In the production of income

The test of whether something is incurred in the production of income is a multifaceted one and includes both objective and subjective criteria. These criteria are dealt with below.

In order for something to be incurred in the production of income there first needs to be a trade (Sub-Nigel Ltd vs Commissioner For Inland Revenue, 1948). In the case of a company in BR it is unlikely that there would be any contention as to whether the company is carrying on a trade.

It is also not a requirement that the income be produced in the same year as the expenditure, it is only required to be incurred in the production of income (Commissioner For Inland Revenue vs Pick 'N Pay Wholesalers (Pty) Ltd, 1987), (Sub-Nigel Ltd vs Commissioner For Inland Revenue, 1948). Therefore, the fact that the company may only be considered rehabilitated or restored at a later date does not preclude the expenditure from being deducted.

As was highlighted in *PE Tramways (Port Elizabeth Electric Tramway Company Ltd vs Commissioner For Inland Revenue, 1936)* expenditure in itself does not produce income, income is produced by the activities of the taxpayer. For this reason PE Tramways applied a twofold test when considering whether an expense was in the production of income, namely, whether the expenditure is:

- Incurred for the purpose of producing an income (subjective test); and
- Sufficiently closely linked to the act which produces the income that it may be considered a cost of performing it (objective test).

The purpose of BR is to, as far as possible, ensure that the company continues to operate in the future. As long as the company continues to operate this would imply that it will continue to produce income. The subjective aspect of this test would therefore be satisfied.

The final consideration that needs to be satisfied is how sufficiently closely linked the expenditure is to the act that produces the income. Over the years the courts have expanded on this concept. These considerations include:

- Whether the expense is an inevitable concomitant of the income earning operations (*Joffe & Co (Pty) Ltd vs Commissioner For Inland Revenue, 1946*);
- Whether the expense would be considered to be incidental to the trade (*Commissioner for Inland Revenue vs Stellenbosch Farmers Winery, 1945*); and
- What the expenditure actually affects (*Commissioner For Inland Revenue vs Genn & Co (Pty) Ltd, 1955*).

In order to apply these principals one would need to determine whether the BR expenses could be considered inevitable or incidental to the income earning operations as well as whether the expenditure has the effect of actually keeping the company operating. Such objective criteria are no doubt dependent on the specific facts of each case, however, as a general principal it can be surmised that a company would not initiate BR unless the company considered BR to be a viable and necessary means of avoiding further financial distress and in worst case liquidation. It may also be further argued that for some companies this may be the only means available to them to limit their financial distress, particularly due to the 'breathing room' BR provides. From this perspective it would appear that, as a general principal, BR expenditure can be sufficiently closely linked to the survival and continued ability of the company to produce income.

We can therefore conclude that while there may be specific exceptions, overall, BR expenditure should be considered to be in the production of income.

5.1.4. Capital vs Revenue nature of BR

The starting point of any capital vs revenue consideration is to first understand the intention of the tax payer (*Elandsheuwel Farming (Edms) Bpk vs Sekretaris Van Binnelandse Inkomste*, 1978) which in this case is the company. As a company itself cannot have an intention we would normally look to the board to determine the intention of the company (*Commissioner For Inland Revenue vs Richmond Estates (Pty) Ltd*, 1956), however, with BR we can look to the Companies Act in order to ascertain the intention of the BR. The primary reason for looking to the Companies Act is due to the fact that the BRP assumes full control and responsibility of the company/board during the BR proceedings.

An additional reason for using the Companies Act as the basis for determining the intention of the Company rather than the board can be attributed to the fact that, in addition to the board, any affected party can initiate the BR proceedings. Further to this, while all affected parties may comment on the BR plan and assist with designing it, it is the creditors that either accept or reject the BR plan. As we saw in Chapter 3 concerning the case of *Beginsel MB and others (The Commissioner for South African Revenue Services vs Beginsel MB and Others*, 2012) the intention of a creditor, particularly a dominant creditor, may not be in accordance with the intention of the board (or company wellbeing). It could therefore be argued that the true intention of the BR is dependent on the intention of the majority creditor(s). To remove this potential ambiguity and for practical reasons only the intention of the Companies Act has been taken into account.

From S128(b) of the Companies Act we know that the primary purpose of BR is to rehabilitate the company. It is thus clear that in order to understand the nature of BR we first need to understand what the nature of a company rehabilitation is. From Chapter 2.1.3 of this dissertation we found that rehabilitation effectively means to 'Restore' the company to good condition, operation, or capacity as well as ensure that the company is able to regain its former rank, privileges and rights. Ultimately BR should reinstate the good name of the company, i.e. the company should be seen as credible and reliable post BR so that the company may enjoy the same benefits and operations that it had prior to BR.

Over the years many principals have been handed down to assist in clarifying this distinction between capital and revenue. The main principals in deciding this may be summarised as follows:

- In deciding whether something is capital or revenue in nature one needs to consider the intention of the tax payer (*Elandsheuwel Farming (Edms) Bpk vs Sekretaris Van Binnelandse Inkomste*, 1978)

- Expenditure incurred in creating or acquiring an income-producing concern must be capital expenditure (Commissioner For Inland Revenue vs George Forest Timber Company Limited, 1924);
- In the absence of any authoritative and comprehensive definition of capital expenditure, one should keep in mind the characteristic quality of capital being wealth employed in creating fresh wealth or invested to produce an income (Commissioner For Inland Revenue vs George Forest Timber Company Limited, 1924);
- Expenditure incurred as part of the income-earning operations are revenue in nature and expenditure incurred in establishing or improving or adding to the income-earning structure would be capital in nature (New State Areas Limited vs the Commissioner of Inland Revenue, 1946); and
- When an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, such expenditure should be regarded as capital in nature (Nchanga Consolidated Copper Mines, Ltd vs Commissioner of Taxes, 1962)

In applying the above principals to the concept of restoring a company the following is evident:

- Assuming that the company does not change in nature or form then the expenditure is not being incurred to create or acquire an income-producing structure. The income-producing structure in this situation would be the company itself which already exists and therefore cannot be recreated or reacquire itself.
- Given that BR is not tangible in nature and not something that one would ordinarily consider to be an investment. If BR were to be considered an investment then it would stand to reason all companies, whether financially distressed or not, would consider investing 'into' BR if the returns justified it. It is therefore clear that BR would not ordinarily be considered capital in nature.
- It is clear that aspects of BR fall within the same categories as the income-earning operations and would therefore be considered revenue in nature, however, the question arises whether BR is establishing or improving or adding to the income-earning structure.

As discussed above BR is not establishing or adding to the income-earning structure as it is not changing the fundamental existence of the business. It can be argued that, dependent, on the BR plan that there may be an improvement in the income-earning structure before and after BR. What needs to keep in mind, however, is that BR is effectively meant to Restore the company and therefore, by definition, does not seek to elevate the

company to a greater position than it was in prior to needing to enter BR. It is therefore clear that BR, overall, does not seek to improve the company.

- BR is not intended to be an ongoing or repeated situation for a company. It is intended to run a fixed course and thereafter, unless an unforeseeable and unconnected situation arises in the future, to no longer be necessary. BR can therefore be considered as a once and for all situation/expenditure.

Once again, as discussed above BR does not bring into account the existence of an asset as the company already exists.

It can be argued that the purpose of BR is to create an advantage for the enduring benefit of trade, however, this in nature is no different to what the average company would be trying to achieve with their day to day operations. Further the concept of restoring something implies that nothing new is being created. Based on the strictest definition it therefore is not appropriate to think of BR as creating an enduring benefit, it would be more appropriate to think of BR as restoring an enduring benefit.

As discussed above a central consideration as to the nature of BR comes down to what one means by rehabilitation. If the rehabilitation is to Restore the company to its previous financial condition or prevent the company from experiencing any further deterioration then this can be likened to the repair or maintenance of a company. If the rehabilitation seeks to elevate the company to a financial condition that it had not previously experienced or in some way fundamentally change the nature and operations of the business this could be likened to an improvement or addition to the company. The key difference between the two aspects may be dependent on the degree to which the restoration takes place or is required to take place (*The Rhodesia Railways Ltd And Others vs Commissioner of Tax, 1925*).

By applying the principals above it is unlikely that BR and associated BR expenditure would be considered capital in nature as in most cases BR would be considered a 'repair' of the company. Exceptions to this principal would be based on the starting position of the company. If, even at its peak operations, the company was not financially viable then it stands to reason that the BR proceedings would have to transcend the principal of a restoration and actually improve upon the previous and current state of the business. In such a scenario it could be argued that the BR is capital in nature rather than revenue in nature.

5.1.5. Not excluded as per S23(g)

S23(g) of the ITA is a limiting provision of the ITA designed to limit the deductibility of company expenditure. A key requirement of S23(g) is that the expenditure must

have been incurred for the purpose of trade. The courts have taken the view that the widest possible meaning should be applied to the definition of trade and have taken it to mean any profitable activity the business may pursue (Burgess vs Commissioner For Inland Revenue, 1993).

The purpose of BR is to, as far as possible, ensure that the company is able to continue to trade in the future. It therefore stands to reason that there is no reason for BR expenses to not be considered for the purpose of trade. While there may be some aspect of the BR proceedings that are not directly related to trade, such as expenditures associated with the administration of BR or court appearances for the extension of BR, these processes and associated expenditure is inseparable from the BR process and therefore would need to be considered part of the trade.

5.1.6. Conclusion

It is clear from the above analysis that the deductibility of BR expenditure can be ambiguous and is dependent on many factors and considerations, many of which, may differ between BR cases. This is particularly relevant for BR cases that conclude that the company should be liquidated as many arguments for BR expenditure being deductible hinge on the company continuing to trade and continuing to produce income.

Overall, provided the company continues to trade, the BR expenditure would meet the requirements of the general deduction formula and therefore be deductible. By applying our EV criteria from Chapter 4 we can determine that the deductibility of this expenditure can have a significant impact on the financial wellbeing of the company (any non-deductible expenses will result in a greater tax obligation and associated cash flow which will result in a reduced EV).

6. Chapter 6: Concluding remarks

Throughout this dissertation we have sought to understand the financial impact that the Tax Laws have on companies in BR and whether these laws support or hinder BR. What is clear from this dissertation is that there are many factors that impact a company in BR and therefore many factors that may lead to the success or failure of BR. The Tax Laws likewise play their part in assisting in the success or failure of BR.

From Chapter 4 it is clear that the Tax Laws, despite the amendments made, currently negatively impact companies in BR and can have the effect of eroding any benefit that a company is able to secure through BR. This problem is not unique to BR and can be attributed to all companies and all tax payers. As much as a tax payer may not like it paying tax, it is a requirement of the country and each tax payer is required to pay his fair share of tax. In this regard the Tax Laws do not appear to be unnecessarily harsh for companies in BR but are not so lenient as to incentivise abuse. SARS, through legislation, appears to have tried to assist companies in various ways by allowing them, in some cases, to limit or defer or completely negate otherwise applicable taxes (refer to the Debt Relief provisions in Chapter 3). Despite the attempts by SARS, through legislation, to reduce the financial impact of taxes more could still be done to allow for longer-term tax relief for BR companies. Currently many of the Debt Relief provisions do not successfully defer tax liabilities and can have a double up effect if assets are sold in the same period that Debt Relief is granted.

While not directly linked to the Tax Laws it was also seen that SARS is not particularly supportive of BR and in many cases prefers for a company to rather be liquidated than enter BR. It is also clear that the agenda of SARS is not in accordance with that of S7(k) of the Companies Act; SARS typically prioritises the receipt of their funds over what may be equitable for all of the stakeholders of the company (The Commissioner for South African Revenue Services vs Beginsel MB and Others, 2012).

All things considered it is unlikely that the Tax Laws will ever be the deciding factor leading to either the success or failure of any BR proceedings. As a general rule the success and failure of a company can be largely attributed to the management of the company and the decisions they make, likewise the success or failure of BR can be largely attributed to the BR practitioner and the strength and completeness of the BR plan put forward. BR plans, on average, seem to give little to no consideration to the Tax Laws applicable or how various company restructurings and tax provisions could be applied to assist BR companies. Instead many BR plans tend to prescribe a compromise with creditors or liquidation, neither of which can be considered ideal scenarios.

Currently there is no consistent approach or universal standard applied amongst BR practitioners to companies in BR. While, practically, this makes sense given the multitude of

different companies, situations and possible turnaround plans that may exist it does not necessarily imply that no standard can or should be formed.

A further problem that is created by BR is that the final decision and ultimate future of the company is left for the creditors to decide. This is a notion that echoes the legislation of the Insolvency Act. Creditors, almost always, have a bias towards protecting their own interests rather than being concerned with the interests of the company. While this prioritisation of creditors may be a practical necessity it goes against S7(k) of the Companies Act which seeks to balance the rights and interests of all the company stakeholders. This may also be a factor leading to the lack of success of BR.

It is recommend that in order to improve the success rate of BR that CIPC should implement measures to better govern BR practitioners including measures to ensure that the BR practitioners appointed are sufficiently skilled in not only legal Companies Act matters but also matters concerning business and the auxiliary laws and regulations applicable to companies such as the Tax Laws. Further some form of measure should be implemented by the Companies Act to limited the potential negative impact on the company based on the prioritisation that creditors receive over other stakeholders.

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